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National Institute of Securities Markets
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Workbook for

NISM-Series-V-A: Mutual Fund Distributors Certification Examination

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Certification Examination

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This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Certification Examination for Mutual Fund Distributors.

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Foreword

NISM is a leading provider of high end professional education, certifications, training and research in financial markets. NISM engages in capacity building among stakeholders in the securities markets through professional education, financial literacy, enhancing governance standards and fostering policy research. NISM works closely with all financial sector regulators in the area of financial education.

NISM Certification programs aim to enhance the quality and standards of professionals employed in various segments of the financial services sector. NISM's School for Certification of Intermediaries (SCI) develops and conducts certification examinations and Continuing Professional Education (CPE) programs that aim to ensure that professionals meet the defined minimum common knowledge benchmark for various critical market functions.

NISM certification examinations and educational programs cater to different segments of intermediaries focusing on varied product lines and functional areas. NISM Certifications have established knowledge benchmarks for various market products and functions such as Equities, Mutual Funds, Derivatives, Compliance, Operations, Advisory and Research.

NISM certification examinations and training programs provide a structured learning plan and career path to students and job aspirants who wish to make a professional career in the Securities markets. Till May 2015, NISM has certified nearly 4 lakh individuals through its Certification Examinations and CPE Programs.

NISM supports candidates by providing lucid and focused workbooks that assist them in understanding the subject and preparing for NISM Examinations. The book covers all important topics to enhance the quality of sales, distribution and related support services in the mutual fund industry. It covers topics related to the basics of mutual funds, their role and structure, different kinds of mutual fund schemes and their features, accounting, valuation and taxation aspects underlying mutual funds and their distribution. This course teaches financial planning as an approach to investing in mutual funds, and an aid for advisors to develop long term relationships with their clients. The book also discusses the concept of scheme evaluation, recommendation of suitable products and services to investors and prospective investors. It will be immensely useful to all those who want to have a better understanding of Indian mutual fund industry.

Sandip Ghose
Director

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NISM gratefully acknowledges the contribution of the Examination Committee for NISM-Series-V-A: Mutual Fund Distributors Certification Examination consisting of representatives of Association of Mutual Funds in India (AMFI).

About NISM

National Institute of Securities Markets (NISM) was established by the Securities and Exchange Board of India (SEBI), in pursuance of the announcement made by the Finance Minister in his Budget Speech in February 2005.

SEBI, by establishing NISM, articulated the desire expressed by the Government of India to promote securities market education and research.

Towards accomplishing the desire of Government of India and vision of SEBI, NISM delivers financial and securities education at various levels and across various segments in India and abroad. To implement its objectives, NISM has established six distinct schools to cater to the educational needs of various constituencies such as investors, issuers, intermediaries, regulatory staff, policy makers, academia and future professionals of securities markets.

NISM is mandated to implement Certification Examinations for professionals employed in various segments of the Indian securities markets.

NISM also conducts numerous training programs and brings out various publications on securities markets with a view to enhance knowledge levels of participants in the securities industry.

About NISM Certifications

The School for Certification of Intermediaries (SCI) at NISM is engaged in developing and administering Certification Examinations and CPE Programs for professionals employed in various segments of the Indian securities markets. These Certifications and CPE Programs are being developed and administered by NISM as mandated under Securities and Exchange Board of India (Certification of Associated Persons in the Securities Markets) Regulations, 2007.

The skills, expertise and ethics of professionals in the securities markets are crucial in providing effective intermediation to investors and in increasing the investor confidence in market systems and processes. The School for Certification of Intermediaries (SCI) seeks to ensure that market intermediaries meet defined minimum common benchmark of required functional knowledge through Certification Examinations and Continuing Professional Education Programmes on Mutual Funds, Equities, Derivatives Securities Operations, Compliance, Research Analysis, Investment Advice and many more.

Certification creates quality market professionals and catalyzes greater investor participation in the markets. Certification also provides structured career paths to students and job aspirants in the securities markets.

About the Workbook

This workbook has been developed to assist candidates in preparing for the National Institute of Securities Markets (NISM) Certification Examination for Mutual Fund Distributors. NISM-Series-V-A: Mutual Fund Distributors Certification Examination seeks to create a common minimum knowledge benchmark for all persons involved in selling and distributing mutual funds including individual Mutual Fund Distributors, employees of organizations engaged in sales and distribution of Mutual Funds, employees of Asset Management Companies specially persons engaged in sales and distribution of Mutual Funds.

The book covers all important topics to enhance the quality of sales, distribution and related support services in the mutual fund industry. It covers topics related to the basics of mutual funds, their role and structure, different kinds of mutual fund schemes and their features, accounting, valuation and taxation aspects underlying mutual funds and their distribution. This course teaches financial planning as an approach to investing in mutual funds, and an aid for advisors to develop long term relationships with their clients. The book also discusses the concept of scheme evaluation, recommendation of suitable products and services to investors and prospective investors.

About the Certification Examination for Mutual Fund Distributors

The examination seeks to create a common minimum knowledge benchmark for all persons involved in selling and distributing mutual funds including:

- Individual Mutual Fund Distributors
- Employees of organizations engaged in sales and distribution of Mutual Funds
- Employees of Asset Management Companies specially persons engaged in sales and distribution of Mutual Funds

The certification aims to enhance the quality of sales, distribution and related support services in the mutual fund industry.

Examination Objectives

On successful completion of the examination, the candidate should:

- Know the basics of mutual funds, their role and structure, different kinds of mutual fund schemes and their features.
- Understand how mutual funds are distributed in the market-place, how schemes are to be evaluated, and how suitable products and services can be recommended to investors and prospective investors in the market.
- Get oriented to the legalities, accounting, valuation and taxation aspects underlying mutual funds and their distribution.
- Get acquainted with financial planning as an approach to investing in mutual funds, and an aid for advisors to develop long term relationships with their clients.

Assessment Structure

The examination consists of 100 questions of 1 mark each and should be completed in 2 hours. The passing score for the examination is 50%. There shall be no negative marking.

How to register and take the examination

To find out more and register for the examination please visit *www.nism.ac.in*

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CHAPTER 1: CONCEPT AND ROLE OF A MUTUAL FUND

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Concepts and role of mutual funds
- Advantages and disadvantages of mutual funds for investors
- Types of mutual fund schemes
- Key development in mutual fund industry over the years

1.1 Introduction

1.1.1 Concept of Mutual Fund

Mutual fund is a vehicle to mobilize moneys from investors, to invest in different markets and securities, in line with the investment objectives agreed upon, between the mutual fund and the investors. In other words, through investment in a mutual fund, an investor can get access to markets that may otherwise be unavailable to them and avail of the professional fund management services offered by an asset management company.

1.1.2 Role of Mutual Funds

Mutual funds perform different roles for the different constituents that participate in it.

Their primary role is to assist investors in earning an income or building their wealth, by participating in the opportunities available in various securities and markets. It is possible for mutual funds to structure a scheme for different kinds of investment objectives. Thus, the mutual fund structure, through its various schemes, makes it possible to tap a large corpus of money from diverse investors.

Therefore, the mutual fund offers *schemes*. In the industry, the words 'fund' and 'scheme' are used inter-changeably. Various categories of schemes are called "funds". In order to ensure consistency with what is experienced in the market, this Workbook goes by the industry practice. However, wherever a difference is required to be drawn, the scheme offering entity is referred to as "mutual fund" or "the fund".

The money that is raised from investors, ultimately benefits governments, companies and other entities, directly or indirectly, to raise moneys to invest in various projects or pay for various expenses.

As a large investor, the mutual funds can keep a check on the operations of the investee company, and their corporate governance and ethical standards.

The projects that are facilitated through such financing, offer employment to people; the income they earn helps the employees buy goods and services offered by other companies, thus supporting projects of these goods and services companies. Thus, overall economic development is promoted.

The mutual fund industry itself, offers livelihood to a large number of employees of mutual funds, distributors, registrars and various other service providers.

Higher employment, income and output in the economy boost the revenue collection of the government through taxes and other means. When these are spent prudently, it promotes further economic development and nation building.

Mutual funds can also act as a market stabilizer, in countering large inflows or outflows from foreign investors. Mutual funds are therefore viewed as a key participant in the capital market of any economy.

1.1.3 Why Mutual Fund Schemes?

Mutual funds seek to mobilize money from all possible investors. Various investors have different investment preferences and needs. In order to accommodate these preferences, mutual funds mobilize different pools of money. Each such pool of money is called a *mutual fund scheme*.

Every scheme has a pre-announced investment objective. Investors invest in a mutual fund scheme whose investment objective reflects their own needs and preference.

1.1.4 How do Mutual Fund Schemes Operate?

Mutual fund schemes announce their investment objective and seek investments from the investor. Depending on how the scheme is structured, it may be open to accept money from investors, either during a limited period only, or at any time.

The investment that an investor makes in a scheme is translated into a certain number of '*Units*' in the scheme. Thus, an investor in a scheme is issued units of the scheme.

Under the law, every unit has a face value of Rs. 10. (However, older schemes in the market may have a different face value). The face value is relevant from an accounting perspective. The number of units multiplied by its face value (Rs. 10) is the capital of the scheme – its *Unit Capital*.

The scheme earns interest income or dividend income on the investments it holds. Further, when it purchases and sells investments, it earns capital gains or incurs capital losses. These are called *realized capital gains* or *realized capital losses* as the case may be.

Investments owned by the scheme may be quoted in the market at higher than the cost paid. Such gains in values on securities held are called *valuation gains*. Similarly, there can be *valuation losses* when securities are quoted in the market at a price below the cost at which the scheme acquired them.

Running the scheme leads to its share of operating expenses (to be discussed in Chapter6).

Investments can be said to have been handled profitably, if the following *profitability metric* is positive:

(A) +Interest income
(B) + Dividend income
(C) + Realized capital gains
(D) + Valuation gains
(E) – Realized capital losses
(F) – Valuation losses
(G) – Scheme expenses

When the investment activity is profitable, the true worth of a unit goes up; when there are losses, the true worth of a unit goes down. The true worth of a unit of the scheme is otherwise called *Net Asset Value* (NAV) of the scheme. The concept of NAV is elaborated in Chapter6.

When a scheme is first made available for investment, it is called a '*New Fund Offer*' (NFO). During the NFO, investors may have the chance of buying the units at their face value. Post-NFO, when they buy into a scheme, they need to pay a price that is linked to its NAV.

The money mobilized from investors is invested by the scheme in a portfolio of securities as per the investment objective committed. Profits or losses, as the case might be, belong to the investors or unitholders. No other entity involved in the mutual fund in any capacity participates in the scheme's profits or losses. They are all paid a fee or commission for the contributions they make to launching and operating the scheme. The investor does not however bear a loss higher than the amount invested by him.

Various investors subscribing to an investment objective might have different expectations on how the profits are to be handled. Some may like it to be paid off regularly as dividends. Others might like the money to grow in the scheme. Mutual funds address such differential expectations between investors within a scheme, by offering various *options*, such as dividend payout option, dividend re-investment option and growth option. The implications of each of these options are discussed in Chapter 7. An investor buying into a scheme gets to select the preferred option also.

The relative size of mutual fund companies is assessed by their *assets under management* (AUM). When a scheme is first launched, assets under management would be the amount mobilized from investors. Thereafter, if the scheme has a positive profitability metric, its AUM goes up; a negative profitability metric will pull it down.

Further, if the scheme is open to receiving money from investors even post-NFO, then such contributions from investors boost the AUM. Conversely, if the scheme pays any money to the investors, either as dividend or as consideration for buying back the units of investors, the AUM falls.

The AUM thus captures the impact of the profitability metric and the flow of unit-holder money to or from the scheme.

1.1.5 Advantages of Mutual Funds for Investors

Professional Management

Mutual funds offer investors the opportunity to earn an income or build their wealth through professional management of their investible funds. There are several aspects to such professional management viz. investing in line with the investment objective, investing based on adequate research, and ensuring that prudent investment processes are followed.

Affordable Portfolio Diversification

Investing in the units of a scheme give investors exposure to a range of securities held in the investment portfolio of the scheme. Thus, even a small investment of Rs. 500 in a mutual fund scheme can give investors ownership of a portion of a diversified investment portfolio.

As will be seen in Chapter12, with diversification, an investor ensures that all the eggs are not in the same basket. Consequently, the investor is less likely to lose money on all the investments at the same time. Thus, diversification helps reduce the risk in investment. In order to achieve the same diversification as a mutual fund scheme, investors will need to set apart several lakhs of rupees. Instead, they can achieve the diversification through an investment of less than thousand rupees in a mutual fund scheme.

Economies of Scale

The pooling of large sums of money from so many investors makes it possible for the mutual fund to engage professional managers to manage the investment. Individual investors with small amounts to invest cannot, by themselves, afford to engage such professional management.

Large investment corpus leads to various other economies of scale. For instance, costs related to investment research and office space get spread across investors. Further, the higher transaction volume makes it possible to negotiate better terms with brokers, bankers and other service providers.

Thus, investing through a mutual fund offers a distinct economic advantage to an investor as compared to direct investing in terms of cost saving.

Liquidity

At times, investors in financial markets are stuck with a security for which they can't find a buyer – worse, at times they can't find the company they invested in! Such investments, whose value the investor cannot easily realise in the market, are technically called illiquid investments and may result in losses for the investor.

Investors in a mutual fund scheme can recover the value of the moneys invested, from the mutual fund itself. Depending on the structure of the mutual fund scheme, this would be possible, either at any time, or during specific intervals, or only on closure of the scheme. Schemes, where the money can be recovered from the mutual fund only on closure of the scheme, are compulsorily listed on a stock exchange. In such schemes, the investor can sell the units in the stock exchange to recover the prevailing value of the investment.

Tax Deferral

As will be discussed in Chapter 6, mutual funds are not liable to pay tax on the income they earn. If the same income were to be earned by the investor directly, then tax may have to be paid in the same financial year.

Mutual funds offer options, whereby the investor can let the moneys grow in the scheme for several years. By selecting such options, it is possible for the investor to defer the tax liability. This helps investors to legally build their wealth faster than would have been the case, if they were to pay tax on the income each year.

Tax benefits

Specific schemes of mutual funds (*Equity Linked Savings Schemes*) give investors the benefit of deduction of the amount subscribed (upto Rs. 150,000 in a financial year), from their income that is liable to tax. This reduces their taxable income, and therefore the tax liability.

The Rajiv Gandhi Equity Savings Scheme (RGESS) offers a rebate to first time retail investors (in equity or mutual funds) with annual income upto Rs. 12 lakhs. Mutual funds announce specific equity-oriented schemes that are eligible for the RGESS benefit.

The RGESS benefit is linked to amount invested (excluding brokerage, securities transaction tax, service tax, stamp duty and all taxes appearing in the contract note). Rebate of 50% of the amount invested upto Rs. 50,000, can be claimed as a deduction from taxable income. The investment limit of Rs. 50,000 is applicable for a block of three financial years, starting with the year of first investment.

Thus, if an investor invests Rs. 30,000 in RGESS schemes in a financial year, then he can reduce his taxable income for that previous year by 50% of Rs. 30,000 i.e. Rs. 15,000. In the following year, he still has an investment limit of Rs. 20,000 available. The maximum deduction that can be made from the taxable income over the period of three financial years is 50% of Rs. 50,000 i.e. Rs. 25,000.

Dividends received from mutual fund schemes are tax-free in the hands of the investors. However, dividends from certain categories of schemes are subject to dividend distribution tax, which is paid by the scheme before the dividend is distributed to the investor. Long term capital gains arising out of sale of some categories of schemes are subject to long term capital gains tax, which may be taxed at a different (and often lower) rate of tax or even entirely tax exempt. Taxation is discussed in detail in Chapter 6.

Convenient Options

The options offered under a scheme allow investors to structure their investments in line with their liquidity preference and tax position.

There is also great transaction conveniences like the ability of withdraw only part of the money from the investment account, ability to invest additional amounts to the account, setting up systematic transactions, etc.

Investment Comfort

Once an investment is made with a mutual fund, they make it convenient for the investor to make further purchases with very little documentation. This simplifies subsequent investment activity.

Regulatory Comfort

The regulator, Securities & Exchange Board of India (SEBI), has mandated strict checks and balances in the structure of mutual funds and their activities. These are detailed in the subsequent Chapters. Mutual fund investors benefit from such protection.

Systematic Approach to Investments

Mutual funds also offer facilities that help investor invest amounts regularly through a *Systematic Investment Plan* (SIP); or withdraw amounts regularly through a *Systematic Withdrawal Plan* (SWP); or move moneys between different kinds of schemes through a *Systematic Transfer Plan* (STP). Such systematic approaches promote investment discipline, which is useful in long-term wealth creation and protection. SWPs allow the investor to structure a regular cash flow from the investment account.

1.1.6 Limitations of a Mutual Fund

Lack of portfolio customization

Some securities houses offer Portfolio Management Schemes (PMS) to large investors. In a PMS, the investor has better control over what securities are bought and sold on his behalf. The investor can get a customised portfolio in case of PMS.

On the other hand, a unit-holder in a mutual fund is just one of several thousand investors in a scheme. Once a unit-holder has bought into the scheme, investment management is left to the fund manager (within the broad parameters of the investment objective). Thus, the unit-holder cannot influence what securities or investments the scheme would buy.

Large sections of investors lack the time or the knowledge to be able to make portfolio choices. Therefore, lack of portfolio customization is not a serious limitation in most cases.

Choice overload

Over 1,950 mutual fund schemes offered by 43 mutual funds – and multiple options within those schemes – make it difficult for investors to choose between them. Greater dissemination of industry information through various media and availability of professional advisors in the market should help investors handle this overload.

No control over costs

All the investor's moneys are pooled together in a scheme. Costs incurred for managing the scheme are shared by all the Unit-holders in proportion to their holding of Units in the scheme. Therefore, an individual investor has no control over the costs in a scheme.

SEBI has however imposed certain limits on the expenses that can be charged to any scheme. These limits, which vary with the size of assets and the nature of the scheme, are discussed in Chapter 6.

1.2 Types of Funds

This section introduces some funds to the reader. The risk aspects underlying these funds and their suitability for different kinds of investors are discussed in later Chapters.

1.2.1 Open-Ended Funds, Close-Ended Funds and Interval Funds

Open-ended funds are open for investors to enter or exit at any time, even after the NFO.

When existing investors acquire additional units or new investors acquire units from the open-ended scheme, it is called a *sale transaction*. It happens at a sale price, which is linked to the NAV.

When investors choose to return any of their units to the scheme and get back their equivalent value, it is called a *re-purchase transaction*. This happens at a re-purchase price that is linked to the NAV.

Although some unit-holders may exit from the scheme, wholly or partly, the scheme continues operations with the remaining investors. The scheme does not have any kind of time frame in which it is to be closed. The on-going entry and exit of investors implies that the unit capital in an open-ended fund would keep changing on a regular basis.

Close-ended funds have a fixed maturity. Investors can buy units of a close-ended scheme, from the fund, only during its NFO. The fund makes arrangements for the units to be traded, post-NFO in a stock exchange. This is done through a *listing* of the scheme in a stock exchange. Such listing is compulsory for close-ended schemes. Therefore, after the NFO, investors who want to buy Units will have to find a seller for those units in the stock exchange. Similarly, investors who want to sell Units will have to find a buyer for those units in the stock exchange. Since post-NFO, sale and purchase of units happen to or from counter-party in the stock exchange – and not to or from the scheme – the unit capital of the scheme remains stable or fixed.

Since the post-NFO sale and purchase transactions happen on the stock exchange between two different investors, and that the fund is not involved in the transaction, the transaction price is likely to be different from the NAV. Depending on the demand-supply situation for the units of the scheme on the stock exchange, the transaction price could be higher or lower than the prevailing NAV.

Interval funds combine features of both open-ended and close-ended schemes. They are largely close-ended, but become open-ended at pre-specified intervals. For instance, an interval scheme might become open-ended between January 1 to 15, and July 1 to 15, each year. The benefit for investors is that, unlike in a purely close-ended scheme, they are not completely dependent on the stock exchange to be able to buy or sell units of the interval fund. However, between these intervals, the Units have to be compulsorily listed on stock exchanges to allow investors an exit route.

The periods when an interval scheme becomes open-ended, are called 'transaction periods'; the period between the close of a transaction period, and the opening of the next transaction period is called 'interval period'. Minimum duration of transaction period is 2 days, and minimum duration of interval period is 15 days. No redemption/repurchase of units is allowed except during the specified transaction period (during which both subscription and redemption may be made to and from the scheme).

1.2.2 Actively Managed Funds and Passive Funds

Actively managed funds are funds where the fund manager has the flexibility to choose the investment portfolio, within the broad parameters of the investment objective of the scheme.

Since this increases the role of the fund manager, the expenses for running the fund turn out to be higher. Investors expect actively managed funds to perform better than the market.

Passive funds invest on the basis of a specified index, whose performance it seeks to track. Thus, a passive fund tracking the BSE Sensex would buy only the shares that are part of the composition of the BSE Sensex. The proportion of each share in the scheme's portfolio would also be the same as the weightage assigned to the share in the computation of the BSE Sensex. Thus, the performance of these funds tends to mirror the concerned index. They are not designed to perform better than the market. Such schemes are also called *index schemes.* Since the portfolio is determined by the index itself, the fund manager has no role in deciding on investments. Therefore, these schemes have low running costs.

Exchange Traded Funds (ETF) are also passive funds whose portfolio replicates an index or benchmark such as an equity market index or a commodity index. The units are issued to the investors in a new fund offer (NFO) after which they are available for sale and purchase on a stock exchange. Units are credited to the investor's demat account and the transactions post-NFO is done through the trading and settlement platforms of the stock exchange. The units of the ETF are traded at real time prices that are linked to the changes in the underlying index.

1.2.3 Debt, Equity and Hybrid Funds

The portfolio of a mutual fund scheme will be driven by the stated investment objective of the scheme. A scheme might have an investment portfolio invested largely in equity shares and equity-related investments like convertible debentures. The investment objective of such funds is to seek capital appreciation through investment in these growth assets. Such schemes are called *equity schemes*.

Schemes with an investment objective that limits them to investments in debt securities like Treasury Bills, Government Securities, Bonds and Debentures are called *debt funds*. These debt securities are discussed in Chapter8.

Hybrid funds have an investment charter that provides for investment in both debt and equity. Some of them invest in gold along with either debt or equity or both. This category of funds is discussed later in this Chapter.

Other funds, such as Gold funds, Real estate funds, Commodity funds and International funds, create portfolios that reflect their investment objectives.

1.2.4 Types of Debt Funds

Debt funds can be categorized on the basis of the type of debt securities they invest in. The distinction can be primarily on the basis of the tenor of the securities: short term or long term, and the issuer: government, corporate, PSUs and others. The risk and return of the securities will vary based on the tenor and issuer. The strategy adopted by the fund manager to create and manage the portfolio can also be a factor for categorizing debt funds.

On the basis of Issuer

Gilt funds invest in only treasury bills and government securities, which do not have a credit risk (i.e. the risk that the issuer of the security defaults). Long-term gilt funds invest in government securities of medium and long-term maturities. There is no risk of default and liquidity is considerably higher in case of government securities. However, prices of long-term government securities are very sensitive to interest rate changes.

Corporate bond funds invest in debt securities issued by companies, including PSUs. There is a credit risk associated with the issuer that is denoted by the credit rating assigned to the security. Such bonds pay a higher coupon income to compensate for the credit risk associated with them

On the basis of Tenor

Liquid schemes or money market schemes are a variant of debt schemes that invest only in short term debt securities. They can invest in debt securities of upto 91 days maturity. However, securities in the portfolio having maturity more than 60-days need to be valued at market prices [“marked to market” (MTM)]. Since MTM contributes to volatility of NAV, fund managers of liquid schemes prefer to keep most of their portfolio in debt securities of less than 60-day maturity. As will be seen later in this Work Book, this helps in positioning liquid schemes as the lowest in price risk among all kinds of mutual fund schemes. Therefore, these schemes are ideal for investors seeking high liquidity with safety of capital.

Short term debt schemes invest in securities with short tenors that have low interest rate risk of significant changes in the value of the securities. Ultra-short term debt funds, short-term debt funds, short-term gilt funds are some of the funds in this category. The contribution of interest income and the gain/loss in the value of the securities and the volatility in the returns from the fund will vary depending upon the tenor of the securities included in the portfolio.

Ultra short-term plans are also known as treasury management funds, or cash management funds. They invest in money market and other short term securities of maturity up to 365 days. The objective is to generate a steady return, mostly coming from accrual of interest income, with minimal NAV volatility.

Short Term Plans combines short term debt securities with a small allocation to longer term debt securities. Short term plans earn interest from short term securities and interest and capital gains from long term securities. Fund managers take a call on the exposure to long term securities based on their view for interest rate movements. If interest rates are expected to go down, these funds increase their exposure to long term securities to benefit from the resultant increase in prices. The volatility in returns will depend upon the extent of long-term debt securities in the portfolio.

Long-term debt schemes such as Gilt funds and Income funds invest in longer-term securities issued by the government and other corporate issuers. The returns from these schemes are significantly impacted by changes in the value of the securities and therefore see greater volatility in the returns.

On the basis of Investment Strategy

Diversified debt funds or Income fund, invest in a mix of government and non-government debt securities such as corporate bonds, debentures and commercial paper. The corporate bonds earn higher coupon income on account of the credit risks associated with them. The government securities are held to meet liquidity needs and to exploit opportunities to capital gains arising from interest rate movements.

Junk bond schemes or high yield bond schemes invest in securities that have a lower credit rating indicating poor credit quality. Such schemes operate on the premise that the attractive returns offered by the investee companies makes up for the losses arising out of a few companies defaulting.

Dynamic debt funds are flexible in terms of the type of debt securities held and their tenors. They do not focus on long or short term securities or any particular category of issuer but look for opportunities to earn income and capital gains across segments of the debt market. Duration of these portfolios are not fixed, but are dynamically managed. If the manager believes that interest rates could move up, the duration of the portfolio is reduced and vice versa.

Fixed maturity plans are a kind of debt fund where the investment portfolio is closely aligned to the maturity of the scheme. AMCs tend to structure the scheme around pre-identified investments. Further, being close-ended schemes, they do not accept moneys post-NFO. Thanks to these characteristics, the fund manager has little ongoing role in deciding on the investment options.

As will be seen in Chapter8, such a portfolio construction gives more clarity to investors on the likely returns if they stay invested in the scheme until its maturity (though there can be no guarantee or assurance of such returns). This helps them compare the returns with alternative investments like bank deposits.

Floating rate funds invest largely in floating rate debt securities i.e. debt securities where the interest rate payable by the issuer changes in line with the market. For example, a debt security where interest payable is described as'5-year Government Security yield plus 1%', will pay interest rate of 7%, when the 5-year Government Security yield is 6%; if 5-year Government Security yield goes down to 3%, then only 4% interest will be payable on that debt security. The NAVs of such schemes fluctuate lesser than other debt funds that invest more in debt securities offering a fixed rate of interest.

1.2.5 Types of Equity Funds

Equity funds invest in equity instruments issued by companies. The funds target long-term appreciation in the value of the portfolio from the gains in the value of the securities held and the dividends earned on it. The securities in the portfolio are typically listed on the stock exchange, and the changes in the price of the securities is reflected in the volatility in the returns from the portfolio. These funds can be categorized based on the type of equity shares that are included in the portfolio and the strategy or style adopted by the fund manager to pick the securities and manage the portfolio.

Diversified equity fund is a category of funds that invest in a diverse mix of securities that cut across sectors and market capitalization. The risk of the fund's performance being significantly affected by the poor performance of one sector or segment is low.

Market Segment based funds invest in companies of a particular market size. Equity stocks may be segmented based on market capitalization as large- cap, mid-cap and small-cap stocks.

- Large- cap funds invest in stocks of large, liquid blue-chip companies with stable performance and returns.
- Mid-cap funds invest in mid-cap companies that have the potential for faster growth and higher returns. These companies are more susceptible to economic downturns and evaluating and selecting the right companies becomes important. Funds that invest in such companies have a higher risk of the companies selected not being able to withstand the slowdown in revenues and profits. Similarly, the price of the stocks also fall more when markets fall.
- Small-cap funds invest in companies with small market capitalisation with intent of benefitting from the higher gains in the price of stocks. The risks are also higher.

Sector funds invest in only a specific sector. For example, a banking sector fund will invest in only shares of banking companies. Gold sector fund will invest in only shares of gold-related companies. The performance of such funds can see periods of under-performance and out-performance as it is linked to the performance of the sector, which tend to be cyclical. Entry and exit into these funds need to be timed well so that the investor does not invest when the sector has peaked and exit when the sector performance falls. This makes the scheme more risky than a diversified equity scheme.

Thematic funds invest in line with an investment theme. For example, an infrastructure thematic fund might invest in shares of companies that are into infrastructure construction, infrastructure toll-collection, cement, steel, telecom, power etc. The investment is thus more broad-based than a sector fund; but narrower than a diversified equity fund and still has the risk of concentration.

Strategy-based Schemes have portfolios that are created and managed according to a stated style or strategy. ***Equity Income / Dividend Yield Schemes*** invest in securities whose shares fluctuate less, and the dividend represents a larger proportion of the returns on those shares. They represent companies with stable earnings but not many opportunities for growth or expansion. The NAV of such equity schemes are expected to fluctuate lesser than other categories of equity schemes. ***Value fund*** invest in shares of fundamentally strong companies that are currently under-valued in the market with the expectation of benefiting from an increase in price as the market recognizes the true value. Such funds have lower risk. They require a longer investment horizon for the strategy to play out. ***Growth Funds*** portfolios feature companies whose earnings are expected to grow at a rate higher than the average rate. These funds aim at providing capital appreciation to the investors and provide above average returns in bullish markets. The volatility in returns is higher in such funds. ***Focussed funds*** hold portfolios concentrated in a limited number of stocks. Selection risks are high in such funds. If the fund manager selects the right stocks then the strategy pays off. If even a few of the stocks do not perform as expected the impact on the scheme's returns can be significant as they constitute a large part of the portfolio.

Equity Linked Savings Schemes (ELSS) are diversified equity funds that offer tax benefits to investors under section 80 C of the Income Tax Act up to an investment limit of Rs. 150000 a year. ELSS are required to hold at least 80% of its portfolio in equity instruments. The investor's the investment is subject to lock-in for a period of 3 years during which period it cannot be redeemed, transferred or pledged.

Rajiv Gandhi Equity Savings Schemes (RGESS) too, as seen earlier, offer tax benefits to first-time investors. Investments are subject to a fixed lock-in period of 1 year, and flexible lock-in period of 2 years.

1.2.6 Types of Hybrid Funds

Hybrid funds invest in a combination of asset classes such as equity, debt and gold. The combination of asset classes used will depend upon the investment objective of the fund. The risk and return in the scheme will depend upon the allocation to each asset class and the type of securities in each asset class that are included in the portfolio. The risk is higher if the equity component is higher. Similarly, the risk is higher if the debt component is invested in longer-term debt securities or lower rated instruments.

Debt-oriented Hybrid funds invest primarily in debt with a small allocation to equity. The equity allocation can range from 5% to 30% and is stated in the offer document. The debt component is conservatively managed to earn coupon income, while the equity component provides the booster to the returns.

Monthly Income Plan is a type of debt-oriented hybrid fund seeks to declare a dividend every month. There is no guarantee that a dividend will be paid each month.

As will be discussed in Unit8, the term 'Monthly Income' is a bit of a misnomer and investor needs to study the scheme properly, before presuming that an income will be received every month.

Equity-oriented Hybrid funds invest primarily in equity, with a portion of the portfolio invested in debt to bring stability to the returns. A very popular category among the equity-oriented hybrid funds is the **Balanced Fund**. These schemes were historically launched for the purpose of giving an investor exposure to both equity and debt simultaneously in one portfolio. The objective of these schemes was to provide growth and stability (or regular income), where equity had the potential to meet the former objective and debt the latter. The balanced funds can have fixed or flexible allocation between equity and debt. One can get the information about the allocation and investment style from the Scheme Information Document.

Capital Protected Schemes are close-ended schemes, which are structured to ensure that investors get their principal back, irrespective of what happens to the market. This is ideally done by investing in Zero Coupon Government Securities whose maturity is aligned to the scheme's maturity. (Zero coupon securities are securities that do not pay a regular interest, but accumulate the interest, and pay it along with the principal when the security matures).

As detailed in the following example, the investment is structured, such that the principal amount invested in the zero-coupon security, together with the interest that accumulates during the period of the scheme would grow to the amount that the investor invested at the start.

Suppose an investor invested Rs 10,000 in a capital protected scheme of 5 years. If 5-year government securities yield 7% at that time, then an amount of Rs 7,129.86 invested in 5-year zero-coupon government securities would mature to Rs 10,000 in 5 years. Thus, by investing Rs 7,129.86 in the 5-year zero-coupon government security, the scheme ensures that it will have Rs 10,000 to repay to the investor in 5 years.

After investing in the government security, Rs 2,870.14 is left over (Rs 10,000 invested by the investor, less Rs 7129.86 invested in government securities). This amount is invested in riskier securities like equities. Even if the risky investment becomes completely worthless (a rare possibility), the investor is assured of getting back the principal invested, out of the maturity moneys received on the government security.

Some of these schemes are structured with a minor difference – the investment is made in good quality debt securities issued by companies, rather than Central Government Securities. Since any borrower other than the government can default, it would be appropriate to view these alternate structures as *Capital Protection Oriented Schemes* rather than *Capital Protected Schemes.*

It may be noted that capital protection can also be offered through a guarantee from a guarantor, who has the financial strength to offer the guarantee. Such schemes are however not prevalent in the market.

Some of the hybrid funds are also launched as **Asset Allocation Funds**. These funds do not specify a minimum or maximum limit for each of the asset classes. The fund manager allocates resources based on the expected performance of each asset class.

Arbitrage funds take opposite positions in different markets / securities, such that the risk is neutralized, but a return is earned. For instance, by buying a share in BSE, and simultaneously selling the same share in the NSE at a higher price. Most arbitrage funds take contrary positions between the equity market and the futures and options market. ('Futures' and 'Options' are commonly referred to as derivatives. These are designed to help investors to take positions or protect their risk in some other security, such as an equity share. They are traded in exchanges like the NSE and the BSE. Chapter10 provides an example of futures contract that is linked to gold).

Although these schemes invest in equity markets, the expected returns are in line with liquid funds.

1.2.7 Real Estate Funds / Real Estate Investment Trusts.

Real Estate Mutual Funds invest in real estate either in the form of physical property or in the form of securities of companies engaged in the real estate business. SEBI's regulations require that at least 35% of the portfolio should be held in physical assets. Securities that these funds can invest in include mortgage-backed securities and debt issuances of companies engaged in real estate projects. Not less than 75% of the net assets of the scheme shall be in physical assets and such securities. Assets held by the fund will be valued every 90 days by two valuers accredited by a credit rating agency. The lower of the two values will be taken to calculate the NAV. These funds are closed-end funds and have to be listed on a stock exchange.

Real Estate Investment Trusts (REIT) are trusts registered with SEBI that invest in commercial real estate assets. The REIT will raise funds through an initial offer and subsequently through follow-on offers, rights issue and institutional placements. The value of the assets owned or proposed to be owned by a REIT coming out with an initial offer will not be less than Rs. 500 crore and the minimum offer size will not be less than Rs.250 crore. The minimum subscription amount in an initial offer shall be Rs. 2 lakh. The units will be listed on the stock exchange.

1.2.8 Commodity Funds

Commodities, as an asset class, include:

- food crops like wheat and gram
- spices like pepper and turmeric
- fibres like cotton
- industrial metals like copper and aluminium
- energy products like oil and natural gas
- precious metals (bullion) like gold and silver

The investment objective of commodity funds would specify which of these commodities it proposes to invest in.

Gold Funds

These funds invest in gold and gold-related securities. They can be structured in either of the following formats:

Gold Exchange Traded fund, which is like an index fund that invests in gold, gold receipts or gold deposit schemes of banks. Each ETF unit typically represents one gram of gold. For every unit of ETF issued, the fund holds gold in the form of physical gold of 99.5 % purity or gold receipts. They are also allowed to invest in the gold deposit schemes of banks to a limit of 20% of the net assets of the scheme. The NAV of such funds moves in line with gold prices in the market.

Gold funds invest in the units of Gold Exchange Traded Funds. They operate just like other mutual funds as far as the investor is concerned.

Gold Sector fund will invest in shares of companies engaged in gold mining and processing. Though gold prices influence these shares, the prices of these shares are more closely linked to the profitability and gold reserves of the companies. Therefore, NAV of these funds do not closely mirror gold prices.

As with gold, such funds can be structured as ***Commodity ETF*** or ***Commodity Sector Funds***. In India, mutual fund schemes are not permitted to invest in commodities, other than Gold (which was discussed earlier). Therefore, the commodity funds in the market are in the nature of Commodity Sector Funds, i.e. funds that invest in shares of companies that are into commodities. Like Gold Sector Funds, Commodity Sector Funds too are a kind of equity fund.

1.2.9 International Funds

International funds invest in markets outside India, by holding certain foreign securities in their portfolio. The eligible securities in Indian international funds include equity shares of companies listed abroad, ADRs and GDRs of Indian companies, debt of companies listed abroad, ETFs of other countries, units of index funds in other countries, units of actively managed mutual funds in other countries. International equity funds may also hold some of their portfolios in Indian equity or debt. They can also hold some portion of the portfolio in money market instruments to manage liquidity. The overseas investment limit for resident individuals has gone up to US$ 125,000 per year.

One way for the fund to manage the investment is to hire the requisite people who will manage the fund. Since their salaries would add to the fixed costs of managing the fund, it can be justified only if a large corpus of funds is available for such investment.

An alternative route would be to tie up with a foreign fund (called the *host fund)*. If an Indian mutual fund sees potential in China, it will tie up with a Chinese fund. In India, it will launch what is called a *feeder fund*. Investors in India will invest in the feeder *fund*. The moneys collected in the feeder fund would be invested in the Chinese host fund. Thus, when the Chinese market does well, the Chinese host fund would do well, and the feeder fund in India will follow suit.

Such feeder funds can be used for any kind of international investment, subject to the scheme objective. The investment could be specific to a country (like the China fund) or diversified across countries. A feeder fund can be aligned to any host fund with any investment objective in any part of the world, subject to legal restrictions of India and the other country.

In such schemes, the local investors invest in rupees for buying the Units. The rupees are converted into foreign currency for investing abroad. They need to be re-converted into rupees when the moneys are to be paid back to the local investors. Since the future foreign currency rates cannot be predicted today, there is an element of foreign currency risk.

As will be clear from Para 8.1.3 in Chapter 8, investor's total return in such schemes will depend on how the international investment performs, as well as how the foreign currency performs. Weakness in the foreign currency can pull down the investors' overall return. At the same time, appreciation in the respective currency will boost the portfolio performance.

1.2.10 Fund of Funds

A Fund of Funds (FoF) is a mutual fund that invests in other mutual funds. It does not hold securities in its portfolio, but other funds that have been chosen to match its investment objective. These funds can be either debt or equity, depending on the objective of the FoF. A FoF either invests in other mutual funds belonging to the same fund house or belonging to other fund houses. FoFs belonging to various mutual fund houses are called multi-manager FoFs, because the AMCs that manage the funds are different. A FoF looks for funds that fit into its investment objective. It specialises in analyzing funds, their performance and strategy and adds or removes funds based on such analysis. A FoF imposes additional cost on the investor, as the expenses of the underlying funds are built into their NAV.

1.2.11 Exchange Traded Funds

Exchange Traded funds (ETF) are open-ended funds, whose units are traded in a stock exchange. Investors buy units directly from the mutual fund only during the NFO of the scheme. Al further purchase and sale transactions in the units are conducted on the stock exchange where the units are listed. The mutual fund issues further units and redeems units directly only in large lots defined as creation units.

Transactions in ETF units on the stock exchange happens at market-determined prices. In order to facilitate such transactions in the stock market, the mutual fund appoints intermediaries called authorized dealers as *market makers*, whose job is to offer a price quote for buying and selling units at all times.

A higher demand for units can push the price of the units higher than the NAV and a lower demand can push down the prices. The authorized dealers can make more units available in the market to meet the higher demand by getting units released by the mutual fund in creation units. They have to submit the underlying assets or cash equivalent with the mutual fund for this. Similarly, they can reduce the available units available in the market by getting units redeemed in creation units.

The major advantage of the market makers is to provide liquidity in the units of the ETFs to the investors.

In a regular open-ended mutual fund, all the purchases of units by investors on a day happen at a single price. Similarly, all the sales of units by investors on a day happen at a single price. The securities market however keeps fluctuating during the day. A key benefit of an ETF is that investors can buy and sell their units in the stock exchange, at real-time prices during the day that closely track the market at that time. This transaction price may be close to the NAV, but not necessarily the same as NAV. Further, the unique structure of ETFs, make them more cost-effective than normal index funds, although the investor would bear a brokerage cost when he transacts with the market maker and need to have a demat account into which the units of the ETF will be credited.

A comparative chart across different types of mutual fund schemes is featured in Chapter 9.

1.2.12 Infrastructure Debt Schemes

These are closed-ended schemes with a tenor of at least five years that invest in debt securities and securitized debt of infrastructure companies. 90% of the fund's portfolio should be invested in the specified securities. The remaining can be invested in the equity shares of infrastructure companies and in money market instruments. The NAV of the scheme will be disclosed at least once each quarter. The minimum investment allowed in these schemes is for Rs. one crore and the minimum face value of each unit shall be Rs. ten lakh. As a closed-ended scheme the units of the scheme will be listed on a stock exchange. An Infrastructure

Debt Scheme can be set up by an existing mutual fund or a new fund set up for this purpose. The sponsor and key personnel must have adequate experience in the infrastructure sector to be able to launch the scheme.

Infrastructure Investment Trusts (InvIT) are trusts registered with SEBI that invest in the infrastructure sector. The InvIT will raise funds from the public through an initial offer of units. The offer shall be for not less than Rs. 250 crores and the value of the proposed assets of the InvIT shall not be less than Rs. 500 crores. The trust will have a minimum 25% public float and atleast 20 investors. The minimum subscription size will be Rs. 10 lakh. The units will be listed on a stock exchange.

1.3 Key Developments over the Years

The mutual fund industry in India has come a long way. Significant spurts in size were noticed in the late 80s, when public sector mutual funds were first permitted, and then in the mid-90s, when private sector mutual funds commenced operations. In the last few years, institutional distributors increased their focus on mutual funds.

The emergence of stock exchange brokers as an additional channel of distribution, the continuing growth in convenience arising out of technological developments, and higher financial literacy in the market should drive the growth of mutual funds in future.

AUM of the industry, as of June 2015 has touched Rs. 11,73,294 crore from 1985 schemes offered by 43 mutual funds. These were distributed as follows: (Source: www.amfiindia.com)

	Open-Ended	*Close-Ended*	*Interval*	**Total**	**% of Total**
INCOME	4,04,442	1,16,967	7,491	**5,28,900**	45%
INFRA DEBT	-	1,442	-	**1,442**	0.10%
EQUITY	3,14,518	18,366	-	**3,32,884**	28%
BALANCED	32,259	-	-	**32,259**	3%
MONEY MARKET/LIQUID	2,06,979	-	-	**2,06,979**	18%
GILT	15,193	-	-	**15,193**	1%
ELSS	36,516	2,913	-	**39,429**	3%
GOLD ETF	6,516	-	-	**6,516**	1%
OTHER ETFS	7,322	-	-	**7,322**	1%
FUND OF FUNDS INVESTING OVERSEAS	2,370	-	-	**2,370**	0.20%

TOTAL	**10,26,115**	**1,39,688**	**7,491**	**11,73,294**	100%
%	81.20%	17.90%	0.90%	100%	

In some advanced countries, mutual fund AUM is a multiple of bank deposits. In India, mutual fund AUM is only about 12.5% of bank deposits. This is indicative of the immense potential for growth of the industry.

The high proportion of AUM in debt, largely from institutional investors is not in line with the role of mutual funds, which is to channelize retail money into the capital market. Various regulatory measures to reduce the costs and increase the conveniences for investors are aimed at transforming mutual funds into a truly retail vehicle of capital mobilization for the larger benefit of the economy.

Sample Questions

1. **Units' of_____________ must be listed on the stock exchange.**
   a. Sector funds
   b. Arbitrage funds
   c. **Close ended funds**
   d. Liquid funds

2. **Open-ended schemes generally offer exit option to investors through a stock exchange.**
   a. True
   b. **False**

3. **Sector funds invest in a diverse range of sectors.**
   a. True
   b. **False**

4. **High yield bond schemes invest in junk bonds.**
   a. **True**
   b. False

5. **Investment objective is closely linked to ________.**
   a. **Scheme**
   b. Option
   c. Plan
   d. SIP

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CHAPTER 2: FUND STRUCTURE AND CONSTITUENTS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Salient features of the legal structure of mutual funds in India
- Role of key constituents and other service providers of the mutual fund eco-system

2.1 Legal Structure of Mutual Funds in India

SEBI (Mutual Fund) Regulations, 1996 as amended till date define “mutual fund” as a fund established in the form of a trust to raise moneys through the sale of units to the public or a section of the public under one or more schemes for investing in securities including money market instruments or gold or gold-related instruments or real estate assets.

Key features of a mutual fund that flows from the definition above are:

- It is established as a trust
- It raises moneys through sale of units to the public or a section of the public
- The units are sold under one or more schemes
- The schemes invest in securities (including money market instruments) or gold or gold-related instruments or real estate assets.

SEBI has stipulated the legal structure under which mutual funds in India need to be constituted. The structure, which has inherent checks and balances to protect the interests of the investors, can be briefly described as follows:

- Mutual funds are constituted as Trusts. Therefore, they are governed by the Indian Trusts Act, 1882
- The mutual fund trust is created by one or more Sponsors, who are the main persons behind the mutual fund business.
- Every trust has beneficiaries. The beneficiaries, in the case of a mutual fund trust, are the investors who invest in various schemes of the mutual fund.
- The operations of the mutual fund trust are governed by a Trust Deed, which is executed between the sponsors and the trustees. SEBI has laid down various clauses that need to be part of the Trust Deed.

- The Trust acts through its trustees. Therefore, the role of protecting the interests of the beneficiaries (investors) is that of the Trustees. The first trustees are named in the Trust Deed, which also prescribes the procedure for change in Trustees.

- In order to perform the trusteeship role, either individuals may be appointed as trustees or a Trustee company may be appointed. When individuals are appointed trustees, they are jointly referred to as 'Board of Trustees'. A trustee company functions through its Board of Directors.

- Day to day management of the schemes is handled by an Asset Management Company (AMC). The AMC is appointed by the sponsor or the Trustees.

- The trustees execute an investment management agreement with the AMC, setting out its responsibilities.

- Although the AMC manages the schemes, custody of the assets of the scheme (securities, gold, gold-related instruments & real estate assets) is with a Custodian, who is appointed by the Trustees.

- Investors invest in various schemes of the mutual fund. The record of investors and their unit-holding may be maintained by the AMC itself, or it can appoint a Registrar & Transfer Agent (RTA).

Let us understand the various agencies, by taking the example of the constitution of SBI Mutual Fund.[1]

Mutual Fund Trust	SBI Mutual Fund
Sponsor	State Bank of India
Trustee	SBI Mutual Fund Trustee Company Private Limited
AMC	SBI Funds Management Private Limited
Custodian	HDFC Bank Limited SBI-SG Global Securities Services Private Limited Bank of Nova Scotia (custodian for Gold)

[1]The names of any market entities used in this workbook are for the purpose of illustration only. No other meaning should be construed in the choice of illustrations. NISM does not recommend any market entity or any product discussed in this workbook.

RTA	Computer Age Management Services Pvt. Ltd

2.2 Key Constituents of a Mutual Fund

2.2.1 Sponsors

The application to SEBI for registration of a mutual fund is made by the sponsor/s. Thereafter, the sponsor invests in the capital of the AMC.

Since sponsors are the main people behind the mutual fund operation, eligibility criteria has been specified as follows:

- The sponsor should have a sound track record and reputation of fairness and integrity in all business transactions. The requirements are:
    - Sponsor should be carrying on business in financial services for not less than 5 years
    - Sponsor should have positive net worth (share capital plus reserves minus accumulated losses) in all the immediately preceding 5 years
    - Net worth in the immediately preceding year should be more than the amount that the sponsor contributes to the capital of the AMC
    - The sponsor should have earned profits, after providing for depreciation and interest and tax, in three of the previous five years, including the latest year.
- The sponsor should be a fit and proper person for this kind of operation.
- The sponsor needs to contribute a minimum 40% of the net worth of the AMC. Further, anyone who holds 40% or more of the net worth of share-holding in the AMC is considered to be a sponsor, and should therefore fulfil the eligibility criteria mentioned above.

In the example of SBI Mutual Fund cited above, the sponsor is State Bank of India, an Indian public sector bank. Sponsorship may be institutional (LIC Nomura Mutual Fund), entirely foreign (like Franklin Templeton Mutual Fund and Goldman Sachs Mutual Fund), predominantly foreign joint venture (like JP Morgan Mutual Fund & HSBC Mutual Fund) or predominantly Indian joint venture (like Birla Sun Life Mutual Fund & ICICI Prudential Mutual Fund).

2.2.2 Trustee

The trustees have a critical role in ensuring that the mutual fund complies with all the regulations, and protects the interests of the unit-holders.

The SEBI Regulations stipulate that:

- Every trustee has to be a person of ability, integrity and standing
- A person who is guilty of moral turpitude cannot be appointed trustee
- A person convicted of any economic offence or violation of any securities laws cannot be appointed as trustee
- No AMC and no director (including independent director), officer, employee of an AMC shall be eligible to be appointed as a trustee of a mutual fund
- No person who is appointed as a trustee of a mutual fund shall be eligible to be appointed as trustee of any other mutual fund.

Prior approval of SEBI needs to be taken, before a person is appointed as Trustee.

The sponsor will have to appoint at least 4 trustees. If a trustee company has been appointed, then that company would need to have at least 4 directors on the Board. Further, at least two-thirds of the trustees / directors on the Board of the trustee company would need to be *independent trustees* i.e. not associated with the sponsor in any way.

SEBI expects Trustees to perform a key role in ensuring legal compliances and protecting the interest of investors. Accordingly, various General Due Diligence and Special Due Diligence responsibilities have been assigned to them. The rights and responsibilities include the following:

- Enter into an Investment Management Agreement with the AMC that will define the functioning of the AMC in making and managing the mutual fund's investments.
- The trustees have the right to seek any information they require from the AMC to facilitate meeting their responsibilities as trustees.
- The trustees shall ensure before the launch of any scheme that all the key personnel and associates such as fund managers, compliance officer, R&T agent, auditors and others have been appointed and all systems are in place.
- The trustees shall periodically review the service contracts entered into for custody arrangements, transfer agency and others and ensure they are in the interest of the unitholders and that all service providers are registered with SEBI.
- They shall ensure that all transactions entered into by the AMC are in compliance with the regulations and the scheme's objectives and intent.
- The trustees shall ensure that the interests of the unitholders are not compromised in any of the AMC's dealings with brokers, other associates and even unitholders of other schemes.
- If the trustees believe that the conduct of the business of the mutual fund is contrary to the provisions of the regulations, then they must take corrective action and inform SEBI of the same.

- The trustees shall not permit a change in the fundamental attributes of the scheme, the trust or fees and expenses or any other change that will affect the interests of the unit holders unless a written communication is sent to each unitholder, a notice is given in the newspaper with national circulation and the unitholders are given the option to exit at NAV without paying an exit load.
- Trustees have to file details of their securities dealings on a quarterly basis with the mutual fund
- On a quarterly basis the trustees shall review the transactions of the mutual fund with the AMC and its associates. They shall also review the net worth of the AMC on a quarterly basis and ensure that any shortfall is made up.
- The trustees shall periodically review the investor complaints received and their redressal by the AMC.
- They shall ensure that the trust property is properly protected, held and administered
- The trustees shall obtain and consider the reports of the auditors and compliance officers in their periodic meetings and take action as required.
- Make half-yearly reposts to SEBI

The strict provisions go a long way in promoting the independence of the role of trusteeship in a mutual fund.

2.2.3 Asset Management Company (AMC)

Day to day operations of asset management is handled by the AMC. The sponsor or, the trustees if so authorized by the trust deed, shall appoint the AMC with the approval of SEBI.

As per SEBI regulations:

- The directors of the asset management company need to be persons having adequate professional experience in finance and financial services related field
- The directors as well as key personnel of the AMC should not have been found guilty of moral turpitude or convicted of any economic offence or violation of any securities laws
- Key personnel of the AMC should not have worked for any asset management company or mutual fund or any intermediary during the period when its registration was suspended or cancelled at any time by SEBI.

Prior approval of the trustees is required, before a person is appointed as director on the board of the AMC.

Further, at least 50% of the directors should be *independent* directors i.e. not associate of or associated with the sponsor or any of its subsidiaries or the trustees.

The AMC needs to have a minimum net worth of Rs. 50 crore. This is immediately applicable to new AMCs. AMCs in existence in May 2014 have been given 3 years to raise their net worth to Rs. 50 crore. However, they cannot launch new schemes until they comply with the Rs. 50 crore net worth requirement.

A change in the controlling interest in the AMC can be made only with the prior approval of the trustees and SEBI, a written communication is sent to unitholders and notice given in a national newspaper and unitholders are given the option to exit at NAV without paying an exit load.

The AMC is responsible for conducting the activities of the mutual fund. It therefore arranges for the requisite offices and infrastructure, engages employees, provides for the requisite software, handles advertising and sales promotion, and interacts with regulators and various service providers.

The AMC has to take all reasonable steps and exercise due diligence to ensure that the investment of funds pertaining to any scheme is not contrary to the provisions of the SEBI regulations and the trust deed. Further, it has to exercise due diligence and care in all its investment decisions.

The appointment of an AMC can be terminated by a majority of the trustees, or by 75% of the Unit-holders. However, any change in the AMC is subject to prior approval of SEBI and the Unit-holders.

Operations of AMCs are headed by a *Managing Director*, *Executive Director* or *Chief Executive Officer*. Some of the other business-heads are:

- *Chief Investment Officer* (CIO), who is responsible for overall investments of the fund. Fund managers assist the CIO. As per SEBI regulations, every scheme requires a fund manager, though the same fund manager may manage multiple schemes.
- *Securities Analysts* support the fund managers through their research inputs. As will be discussed in Chapter8, these analysts come from two streams, Fundamental Analysis and Technical Analysis. Some mutual funds also have an economist to analyse the economy.
- *Securities Dealers* help in putting the transactions through in the market. The mutual fund schemes' sale and purchase of investments are executed by the dealers in the secondary market.
- *Chief Marketing Officer* (CMO), who is responsible for mobilizing money under the various schemes. Direct Sales Team (who generally focus on large investors), Channel Managers (who manage the distributors) and Advertising & Sales Promotion Team support the CMO.
- *Chief Operations Officer* (COO) handles all operational issues.
- *Compliance Officer* needs to ensure all the legal compliances. In Offer Documents of new issues, he signs a due-diligence certificate to the effect that all regulations have been complied with, and that all the intermediaries mentioned in the offer document have the requisite statutory registrations and approvals.

In order to ensure independence, the Compliance Officer reports directly to the head of the AMC. Further, he works closely with the Trustees on various compliance and regulatory issues.

AMCs are required to invest seed capital of 1% of the amount raised subject to a maximum of Rs.50 lakh in all the open-ended schemes of the mutual fund through the lifetime of the scheme.

2.3 Other Service Providers

2.3.1 Custodian

The custodian has custody of the assets of the fund. As part of this role, the custodian needs to accept and give delivery of securities for the purchase and sale transactions of the various schemes of the fund. Thus, the custodian settles all the transactions on behalf of the mutual fund schemes.

All custodians need to register with SEBI. The Custodian is appointed by the trustees. A custodial agreement is entered into between the trustees and the custodian.

The SEBI regulations provide that if the sponsor or its associates control 50% or more of the shares of a custodian, or if 50% or more of the directors of a custodian represent the interest of the sponsor or its associates, then, unless certain specific conditions are fulfilled, that custodian cannot be appointed for the mutual fund operation of the sponsor or its associate or subsidiary company.

An independent custodian ensures that the securities are indeed held in the scheme for the benefit of investors – an important control aspect.

The custodian also tracks corporate actions such as dividends, bonus and rights in companies where the fund has invested.

2.3.2 RTA

The RTA maintains investor records. Their offices in various centres serve as Investor Service Centres (ISCs), which perform a useful role in handling the documentation of investors. The functions of the RTA includes processing of purchase and redemption transactions of the investor and dealing with the financial transactions of receiving funds for purchases and making payments for redemptions, updating the unit capital of the scheme to reflect these transactions, updating the information in the individual records of the investor, called folios, keeping the investor updated about the status of their investment account and information related to the investment.

The appointment of RTA is done by the AMC. It is not compulsory to appoint a RTA. The AMC can choose to handle this activity in-house. All RTAs need to register with SEBI.

2.3.3 Auditors

Auditors are responsible for the audit of accounts.

Accounts of the schemes need to be maintained independent of the accounts of the AMC.

The auditor appointed to audit the scheme accounts needs to be different from the auditor of the AMC.

While the scheme auditor is appointed by the Trustees, the AMC auditor is appointed by the AMC.

2.3.4 Fund Accountants

The fund accountant performs the role of calculating the NAV, by collecting information about the assets and liabilities of each scheme. The AMC can either handle this activity in-house, or engage a service provider. There is no need for a registration with SEBI to perform this function.

2.3.5 Distributors

Distributors have a key role in selling suitable types of units to their clients i.e. the investors in the schemes of mutual funds with whom they are empanelled. A distributor can be empanelled with more than one mutual fund. Distributors can be individuals or institutions such as distribution companies, broking companies and banks.

Distributors need to pass the prescribed certification test, and register with AMFI. Regulatory aspects of their role are discussed in Chapter3, while some of the distribution and channel management practices are covered in Chapter5.

2.3.6 Collecting Bankers

The investors' moneys go into the bank account of the scheme they have invested in. These bank accounts are maintained with collection bankers who are appointed by the AMC.

Leading collection bankers make it convenient to invest in the schemes by accepting applications of investors in most of their branches. Payment instruments against applications handed over to branches of the AMC or the RTA need to be banked with the collecting bankers, so that the moneys are available for investment by the scheme. Thus, the banks enable collection and payment of funds for the schemes.

Through this kind of a mix of constituents and specialized service providers, most mutual funds maintain high standards of service and safety for investors.

2.3.7 KYC Registration Agencies

To do away with multiple KYC formalities with various intermediaries, SEBI has mandated a unified KYC for the securities market through KYC Registration Agencies registered with SEBI. Any new investor, Joint holders, Power of Attorney holders, Donors and Guardian (in case of minors) have to comply with the KYC formalities. In-Person Verification (IPV) by a SEBI-registered intermediary is compulsory for all investors. However, the investor needs to get IPV done by only one SEBI-registered intermediary (broker, depository, mutual fund distributor etc.). This IPV will be valid for transactions with other SEBI-registered intermediaries too.

Distributors who have a valid NISM-Series-V-A: Mutual Fund Distributors certificate and a valid ARN can carry out the In-person verification if they have completed the KYD process.

Sample Questions

1. The assets of the mutual fund are held by ______.

a. AMC
b. Trustees
c. Custodian
d. Registrar

2. Minimum networth requirement for a new AMC is _______.

a. Rs 50 crore
b. Rs 5 crore
c. Rs 4 crore
d. Rs 10 crore

3. AMC directors are appointed with the permission of Trustees.

a. True
b. False

4. Most investor service centres are offices of _______.

a. Trustees
b. Registrar
c. Custodian
d. Fund Accountant

5. Fund accounting activity of a scheme is to be compulsorily outsourced.

a. True
b. False

CHAPTER 3: LEGAL AND REGULATORY ENVIRONMENT

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Regulatory environment of mutual funds in India
- Rights and obligations of investors
- AMFI's Code of Ethics
- AMFI's Code of Conduct for Intermediaries of mutual funds

3.1 Role of Regulators in India

3.1.1 SEBI

SEBI is the regulatory authority for securities markets in India. It regulates, among other entities, mutual funds, depositories, custodians and registrars & transfer agents in the country.

The applicable guidelines for mutual funds are set out in SEBI (Mutual Funds) Regulations, 1996, as amended till date. Some aspects of these regulations are discussed in various sections of this Workbook. An updated and comprehensive list of circulars issued by SEBI can be found in the Mutual Funds section of SEBI's website www.sebi.gov.in. Master Circulars[2], which captures the essence of various circulars issued upto a specified date, may be downloaded from www.sebi.gov.in.

Some segments of the financial markets have their own independent regulatory bodies. Wherever applicable, mutual funds need to comply with these other regulators also. For instance, RBI regulates the money market and foreign exchange market in the country. Therefore, mutual funds need to comply with RBI's regulations regarding investment in the money market, investments outside the country, investments from people other than Indians resident in India, remittances (inward and outward) of foreign currency etc.

Stock Exchanges are regulated by SEBI. Every stock exchange has its own listing, trading and margining rules. Mutual Funds need to comply with the rules of the exchanges with which they choose to have a business relationship.

Anyone who is aggrieved by a ruling of SEBI, can file an appeal with the Securities Appellate Tribunal (SAT).

[2]Candidates are advised to read the SEBI master circulars.

3.1.2 Self-Regulatory Organizations (SRO)

In the developed world, it is common for market players to create Self-Regulatory Organizations, whose prime responsibility is to regulate their own members. Wherever SROs exist, the statutory regulatory bodies set up by the Government (like SEBI in India) only lay down the broad policy framework, and leave the micro-regulation to the SRO.

For instance, the Institute of Chartered Accountants of India (ICAI) regulates its own members.

The Mutual Funds industry in India is in the process of getting an SRO to oversee its distributors.

3.1.3 AMFI Objectives

AMCs in India are members of AMFI, an industry body that has been created to promote the interests of the mutual funds industry [like Confederation of Indian Industry (CII) for overall industry and NASSCOM for the IT/BPO industry]. AMFI is not an SRO.

The objectives of AMFI are as follows:

- To define and maintain high professional and ethical standards in all areas of operation of mutual fund industry.
- To recommend and promote best business practices and code of conduct to be followed by members and others engaged in the activities of mutual fund and asset management including agencies connected or involved in the field of capital markets and financial services.
- To interact with the Securities and Exchange Board of India (SEBI) and to represent to SEBI on all matters concerning the mutual fund industry.
- To represent to the Government, Reserve Bank of India and other bodies on all matters relating to the mutual fund Industry.
- To develop a cadre of well-trained agent-distributors and to implement a programme of training and certification for all intermediaries and others engaged in the industry.
- To undertake nationwide investor awareness programme so as to promote proper understanding of the concept and working of mutual funds.
- To disseminate information on mutual fund Industry and to undertake studies and research directly and/or in association with other bodies.

3.1.4 AMFI Code of Ethics (ACE)

The AMFI Code of Ethics sets out the standards of good practices to be followed by the Asset Management Companies in their operations and in their dealings with investors, intermediaries and the public.

SEBI (Mutual Funds) Regulation, 1996 requires all Asset Management Companies and Trustees to abide by the Code of Conduct as specified in the Fifth Schedule to the Regulation. The AMFI Code has been drawn up to supplement that schedule, to encourage standards higher than those prescribed by the Regulations for the benefit of investors in the mutual fund industry. Appendix 1 has the details.

While the SEBI Code of Conduct lays down broad principles, the AMFI code of ethics (ACE) sets more explicit standards for AMCs and Trustees.

3.1.5 AMFI's Code of Conduct for Intermediaries of Mutual Funds

AMFI has also framed a set of guidelines and code of conduct for intermediaries (known as AMFI Guidelines & Norms for Intermediaries (AGNI)), consisting of individual agents, brokers, distribution houses and banks engaged in selling of mutual fund products. The Code of Conduct is detailed in Appendix 2. Apart from AMFI, SEBI also has made it mandatory for intermediaries to follow the Code of Conduct.

In the event of breach of the Code of Conduct by an intermediary, the following sequence of steps is provided for:

- Write to the intermediary (enclosing copies of the complaint and other documentary evidence) and ask for an explanation within 3 weeks.
- In case explanation is not received within 3 weeks, or if the explanation is not satisfactory, AMFI will issue a warning letter indicating that any subsequent violation will result in cancellation of AMFI registration.
- If there is a proved second violation by the intermediary, the registration will be cancelled, and intimation sent to all AMCs.

The intermediary has a right of appeal to AMFI.

3.1.6 Guidelines for Circulation of Unauthenticated News

SEBI has issued guidelines to all market intermediaries relating to circulation of unauthenticated news through various modes of communication. Following are the guidelines stipulated by SEBI:

- Proper internal code of conduct and controls should be put in place by market intermediaries registered with SEBI. Employees/temporary staff/voluntary workers etc.

employed/working in the offices of market intermediaries should not encourage or circulate rumours or unverified information obtained from client, industry, any trade or any other sources without verification.

- Access to Blogs/Chat forums/Messenger sites etc. should either be restricted under supervision or access should not be allowed.
- Logs for any usage of such Blogs/Chat forums/Messenger sites (called by any nomenclature) have to be treated as records and the same should be maintained as specified by the respective Regulations which govern the concerned intermediary.
- Employees should be directed that any market related news received by them either in their official mail/personal mail/blog or in any other manner, should be forwarded only after the same has been seen and approved by the concerned Intermediary's Compliance Officer. If an employee fails to do so, he/she shall be deemed to have violated the various provisions contained in SEBI Act/Rules/Regulations etc. and shall be liable for action. The Compliance Officer shall also be held liable for breach of duty in this regard.

3.1.7. Due Diligence Process by AMCs for Distributors of Mutual Funds

SEBI has mandated AMCs to put in place a due diligence process to regulate distributors who qualify any one of the following criteria:

a. Multiple point presence (More than 20 locations)
b. AUM raised over Rs. 100 crore across industry in the non-institutional category but including high networth individuals (HNIs)
c. Commission received of over Rs. 1 Crore p.a. across industry
d. Commission received of over Rs. 50 Lakhs from a single mutual fund

At the time of empanelling distributors and during the period i.e. review process, mutual funds/AMCs have to undertake a due diligence process to satisfy 'fit and proper' criteria that incorporate, amongst others, the following factors:

a. Business model, experience and proficiency in the business.
b. Record of regulatory / statutory levies, fines and penalties, legal suits, customer compensations made; causes for these and resultant corrective actions taken.
c. Review of associates and subsidiaries on above factors.
d. Organizational controls to ensure that the following processes are delinked from sales and relationship management processes and personnel:
   i.) Customer risk / investment objective evaluation.
   ii.) MF scheme evaluation and defining its appropriateness to various customer risk categories.
   iii.) In this respect, customer relationship and transactions shall be categorized as:

a. Advisory – where a distributor represents to offer advice while distributing the product, it will be subject to the principle of 'appropriateness' of products to that customer category. Appropriateness is defined as selling only that product categorization that is identified as best suited for investors within a defined upper ceiling of risk appetite. No exception shall be made.
b. Execution Only – in case of transactions that are not booked as 'advisory', it shall still require:
   i. If the distributor has information to believe that the transaction is not appropriate for the customer, a written communication be made to the investor regarding the unsuitability of the product. The communication shall have to be duly acknowledged and accepted by investor.
   ii. A customer confirmation to the effect that the transaction is 'execution only' notwithstanding the advice of inappropriateness from that distributor be obtained prior to the execution of the transaction.
   iii. That on all such 'execution only' transactions, the customer is not required to pay the distributor anything other than the standard flat transaction charges.
c. There shall be no third categorization of customer relationship / transaction.
d. While selling mutual fund products of the distributors' group/affiliate/associates, the distributor shall make disclosure to the customer regarding the conflict of interest arising from the distributor selling such products.

Compliance and risk management functions of the distributor shall include review of defined management processes for:

a. The criteria to be used in review of products and the periodicity of such review.
b. The factors to be included in determining the risk appetite of the customer and the investment categorization and periodicity of such review.
c. Review of transactions, exceptions identification, escalation and resolution process by internal audit.
d. Recruitment, training, certification and performance review of all personnel engaged in this business.
e. Customer on-boarding and relationship management process, servicing standards, enquiry / grievance handling mechanism.
f. Internal / external audit processes, their comments / observations as it relates to MF distribution business.
g. Findings of ongoing review from sample survey of investors.

Mutual funds/AMCs may implement additional measures as deemed appropriate to help achieve greater investor protection.

3.2 Investment Restrictions for Schemes

The SEBI Regulations provide for various limits to the kind of investments that are possible in mutual fund schemes, and the limits thereof. In a few cases, there are also aggregate limits for all schemes of a mutual fund together. The regulator's objective behind setting these limits is to ensure a minimum level of portfolio diversification. These limits are beyond the scope of this Work Book.

However, every distributor and investor ought to know the following investment boundaries of schemes.

3.2.1 Investment Objective

This defines the broad investment charter. For example, the investment objective of a *diversified equity scheme* might read as follows:

"To generate capital appreciation from a portfolio of predominantly equity related securities"

The investment objective of a *diversified debt scheme* could be:

"To generate income by investing predominantly in a wide range of debt and money market securities"

A *balanced scheme* would have an investment objective like:

"To achieve growth by investing in equity and equity related investments, balanced with income generation by investing in debt and money market instruments"

3.2.2 Investment Policy

This describes in greater detail, the kind of portfolio that will be maintained. For example:

"The portfolio will generally comprise of equity and equity related instruments of around 30 companies, which may go upto 39 companies"; or

"Investment will be predominantly in mid-cap stocks"; or

"More than 50% will be invested in equity and equity related securities; the rest would be in debt and money market securities"

"The scheme may use derivatives only to the extent of 35% of its net assets"

When a scheme's name implies investment in a particular kind of security or sector, it should have a policy that provides for investing at least 65% of its corpus in that security or sector, in normal times. Thus, a debt scheme would need to invest at least 65% in debt securities; an equity scheme would need to invest that much in equities; a steel sector fund would need to invest at least 65% in shares of steel companies.

3.2.3 Investment Strategy

Investment strategy goes into details such as:

- Should we increase the liquidity component in a scheme
- Should we go overweight on the steel sector

While the investment objective and investment policy are part of the offer document, investment strategy is decided more frequently. Many AMCs have a practice, where every morning, the senior management (CEO, CIO, and Fund Managers) discuss the need for any change in their investment strategy.

3.3 Investors' Rights & Obligations

3.3.1 Service Standards Mandated for a Mutual Fund towards its Investors

- Schemes other than ELSS and RGESS can remain open for subscription for a maximum of fifteen days.
- In the case of RGESS schemes, the offering period shall be not be more than thirty days.
- Schemes, other than ELSS and RGESS, need to allot units or refund moneys within 5 business days of closure of the NFO. RGESS schemes are given a period of 15 days from closure of the NFO to make the refunds.
- In the event of delays in refunds, investors need to be paid interest at the rate of 15% p.a. for the period of the delay. This interest cannot be charged to the scheme.
- Open-ended schemes, other than ELSS, have to re-open for ongoing sale / re-purchase within 5 business days of allotment.
- Statement of accounts are to be sent to investors as follows:
    - In the case of NFO - within 5 business days of closure of the NFO (15 days for RGESS).
    - In the case of post-NFO investment – within 5 working days from the day of receiving the receipt of request from the unitholders, a confirmation has to be sent to the registered email or mobile phone giving details of the number of units allotted
    - In the case of SIP / STP / SWP
        - Initial transaction – within 10 working days
        - Ongoing – once every calendar quarter (March, June, September, December) within 10 working days of the end of the quarter

  - On specific request by investor, it will be dispatched to investor within 5 working days without any cost.
  - Statement of Account shall also be sent to dormant investors i.e. investors who have not transacted during the previous 6 months. This can be sent along with the Portfolio Statement / Annual Return, with the latest position on number and value of Units held.
  - If mandated by the investor, soft copy shall be e-mailed to investor every month.
- Consolidated Statement of Accounts (across mutual funds based on PAN of the investor) too is to be sent to the investor for each calendar month in which there are transactions in the folio, as detailed in Chapter 7.
- Units of all mutual fund schemes held in demat form are freely transferable. Investors have the option to receive allotment of mutual fund units of open ended and closed end schemes in their demat account.
- Only in the case of ELSS and RGESS Schemes, free transferability of units (whether demat or physical) is curtailed for the statutory minimum holding period.
- Investor can ask for a Unit Certificate for his Unit-holding. This is different from a Statement of Account as follows:
  - A Statement of Account shows the opening balance, transactions during the period and closing balance

    A Unit Certificate only mentions the number of Units held by the investor.
  - In a way, the Statement of Account is like a bank pass book, while the Unit Certificate is like a Balance Confirmation Certificate issued by the bank.
  - Since Unit Certificates are non-transferable, they do not offer any real transactional convenience for the Unit-holder. However, if a Unit-holder asks for it, the AMC is bound to issue the Unit Certificate within 5 working days of receipt of request (15 days for RGESS).
- NAV has to be published daily, in at least 2 daily newspapers having circulation all over India
- NAV and re-purchase price are to be updated in the website of AMFI and the mutual fund
  - In the case of Fund of Funds, by 10 am the following day
  - In the case of other schemes, by 9 pm the same day
- The investor/s can appoint upto 3 nominees, who will be entitled to the Units in the event of the demise of the investor/s. The investor can also specify the percentage distribution

between the nominees. If no distribution is indicated, then an equal distribution between the nominees will be presumed.

- The investor can also pledge the units. This is normally done to offer security to a financier.
- Dividend warrants have to be dispatched to investors within 30 days of declaration of the dividend.
- Redemption / re-purchase cheques would need to be dispatched to investors within 10 working days from the date of receipt of transaction request.
- In the event of delays in dispatching dividend warrants or redemption / repurchase cheques, the AMC has to pay the unit-holder, interest at the rate of 15% p.a. This expense has to be borne by the AMC i.e. it cannot be charged to the scheme.

3.3.2 Other Rights of Investors

Unit-holders have proportionate right to the beneficial ownership of the assets of the scheme.

Investors can choose to change their distributor or go direct. This needs to be done through a written request by the investor. In such cases, AMCs will need to comply, without insisting on any kind of No Objection Certificate from the existing distributor.

Investors can choose to hold the Units in dematerialised form. The mutual fund / AMC is bound to co-ordinate with the RTA and Depository to facilitate this.

In the case of unit-holding in demat form, the demat statement given by the Depository Participant would be treated as compliance with the requirement of Statement of Account.

The mutual fund has to publish a complete statement of the scheme portfolio and the half-yearly unaudited financial results, within 1 month from the close of each half year. The advertisement has to appear in one National English daily, and one newspaper published in the language of the region where the head office of the mutual fund is situated.

In lieu of the advertisement, the mutual fund may choose to send the portfolio statement to all Unit-holders.

Debt-oriented, close-ended / interval, schemes /plans need to disclose their portfolio in their website every month, by the 3rd working day of the succeeding month.

Unit-holders have the right to inspect key documents such as the Trust Deed, Investment Management Agreement, Custodial Services Agreement, RTA agreement and Memorandum & Articles of Association of the AMC.

SEBI has prescribed a detailed format for annual reporting on redressal of complaints received against the mutual fund (including its authorised persons, distributors, employees etc.). The report categorises different kinds of complaints. For each complaint category, the mutual fund has to report on the number of complaints, the time period in which they were resolved, and if not resolved, for how long they remain unresolved. The trustees have to sign off on this report, which is to be disclosed in AMFI website, the website of the individual mutual fund, and it's Annual Report.

Scheme-wise Annual Report or an abridged summary has to be mailed to all unit-holders within 6 months of the close of the financial year.

The Annual Report of the AMC has to be displayed on the website of the mutual fund. The Scheme-wise Annual Report will mention that unit-holders can ask for a copy of the AMC's Annual Report.

In the event of any issue with the AMC or scheme, the investor can first approach the investor service centre. If the issue is not redressed, even after taking it up at senior levels in the AMC, then the investor can write to SEBI with the details.

Further, the offer document has details of the number of complaints received and their disposal. Pending investor complaints can be a ground for SEBI to refuse permission to the AMC to launch new schemes.

The trustees / AMC cannot make any change in the fundamental attributes of a scheme, unless

i. A written communication about the proposed change is sent to each Unit-holder, and an advertisement is issued in an English daily newspaper having nationwide circulation, and in a newspaper published in the language of the region where the head office of the mutual fund is located.

ii. Dissenting unit-holders are given the option to exit at the prevailing Net Asset Value, without any exit load. This exit window has to be open for at least 30 days.

The appointment of the AMC for a mutual fund can be terminated by a majority of the trustees or by 75% of the unit-holders (in practice, Unit-holding) of the Scheme.

75% of the unit-holders (in practice, Unit-holding) can pass a resolution to wind-up a scheme.

The Trustees are bound to obtain consent of the unit-holders:

- Whenever required to do so by SEBI, in the interest of the unit-holders
- Whenever required to do so by 75% of the unit-holders (in practice, Unit-holding) of the scheme
- When the trustees decide to wind-up or prematurely redeem the scheme

If an investor feels that the trustees have not fulfilled their obligations, then he can file a suit against the trustees for breach of trust.

Merger or consolidation of schemes is not considered a change in the fundamental attribute **of the surviving scheme** if the following conditions are met:

a) There is no other change in the Fundamental attributes of the surviving scheme i.e. the scheme which remains in existence after the merger.

b) Mutual Funds are able to demonstrate that the circumstances merit merger or consolidation of schemes and the interest of the unit holders of surviving scheme is not adversely affected.

3.3.3 Limitation of Rights of Unit-holders

Under the law, a trust is a notional entity. Therefore, investors cannot sue the trust (but they can file suits against trustees, as seen above).

The principle of *caveat emptor* (let the buyer beware) applies to mutual fund investments. So, the unit-holder cannot seek legal protection on the grounds of not being aware, especially when it comes to the provisions of law, and matters fairly and transparently stated in the Offer Document.

Unit-holders have a right to proceed against the AMC or trustees in certain cases. However, a proposed investor i.e. someone who has not invested in the scheme does not have the same rights.

The Companies Act, 2013 offers some protection to share-holders and people who invest in fixed deposits in companies. An investor in a mutual fund scheme is however, neither a share-holder, nor a fixed deposit-holder – and the mutual fund scheme is in any case not a company. Therefore, these protections under the Companies Act, 2013 are not available to investors in a mutual fund scheme.

3.3.4 Unclaimed Amounts

The mutual fund has to deploy unclaimed dividend and redemption amounts in the money market. AMC can recover investment management and advisory fees on management of these unclaimed amounts, at a maximum rate of 0.50% p.a.

Recovery of such unclaimed amounts by the investors is as follows:

- If the investor claims the money within 3 years, then payment is based on prevailing NAV i.e. after adding the income earned on the unclaimed money

- If the investor claims the money after 3 years, then payment is based on the NAV at the end of 3 years

AMC is expected to make a continuous effort to remind the investors through letters to claim their dues.

The Annual Report has to mention the unclaimed amount and the number of such investors for each scheme.

3.3.5 Proceeds of Illiquid Securities

It is possible that a security was treated as wholly or partly non-recoverable at the time of maturity or winding up of a scheme. The security may subsequently yield a higher amount to the scheme. Treatment of such excess is as follows:

- If the amounts are substantial, and recovered within 2 years, then the amount is to be paid to the old investors
- In other cases, the amount is to be transferred to the Investor Education Fund maintained by each mutual fund.

3.3.6 Investor's Obligations

PAN No. and KYC documentation are compulsory for mutual fund investments. Only exception is micro-SIPs. This is discussed in detail in Chapter 7.

Investors need to give their bank account details along with the redemption request.

3.4 Can a Mutual Fund Scheme go bust?

While the AMC manages the investments of the scheme, the assets of the scheme are held by the Custodian. Both operate under the overall control of the Trustees. This system of checks and balances protects the investors from misappropriation of funds, fraud etc.

Even if some sponsors wish to move out of the business, they need to bring in some other sponsor, acceptable to SEBI, before they can exit. The new sponsor would need to put in place the entire framework of Trustees, AMC etc. Therefore, unlike the occasional experience of 'vanishing companies' in shares and fixed deposits, mutual funds cannot vanish.

It is also pertinent to note that the custodian has custody of the investments in a scheme. As seen in Chapter 2, the custodian is largely independent of the sponsor and the AMC. This ensures structural protection of the scheme assets for the benefit of investors.

Further, in the event of a change in sponsorship that an investor is not comfortable with, the option of exiting from the scheme with the full NAV is available for a 30-day period.

These structural requirements ensure that the investor is fully protected from most of the contingencies that can be envisaged.

3.5 Appendix 1: AMFI Code of Ethics

AMFI Code of Ethics (ACE)

1.0 INTEGRITY

1.1 Members and their key personnel, in the conduct of their business shall observe high standards of integrity and fairness in all dealings with investors, issuers, market intermediaries, other members and regulatory and other government authorities.

1.2 Mutual Fund Schemes shall be organized, operated, managed and their portfolios of securities selected, in the interest of all classes of unit holders and not in the interest of:

- sponsors
- directors of Members
- members of Board of Trustees or directors of the Trustee company
- brokers and other market intermediaries
- associates of the Members
- a special class selected from out of unitholders

2.0 DUE DILIGENCE

2.1 Members in the conduct of their Asset Management business shall at all times

- render high standards of service.
- exercise due diligence.
- exercise independent professional judgment.

2.2 Members shall have and employ effectively adequate resources and procedures which are needed for the conduct of Asset Management activities.

3.0 DISCLOSURES

3.1 Members shall ensure timely dissemination to all unitholders of adequate, accurate, and explicit information presented in a simple language about the investment objectives, investment policies, financial position and general affairs of the scheme.

3.2 Members shall disclose to unitholders investment pattern, portfolio details, ratios of expenses to net assets and total income and portfolio turnover wherever applicable in respect of schemes on annual basis.

3.3 Members shall in respect of transactions of purchase and sale of securities entered into with any of their associates or any significant unitholder

- submit to the Board of Trustees details of such transactions, justifying its fairness to the scheme.
- disclose to the unitholders details of the transaction in brief through annual and half yearly reports.

3.4 All transactions of purchase and sale of securities by key personnel who are directly involved in investment operations shall be disclosed to the compliance officer of the member at least on half yearly basis and subsequently reported to the Board of Trustees if found having conflict of interest with the transactions of the fund.

4.0 PROFESSIONAL SELLING PRACTICES

4.1 Members shall not use any unethical means to sell, market or induce any investor to buy their products and schemes

4.2 Members shall not make any exaggerated statement regarding performance of any product or scheme.

4.3 Members shall endeavour to ensure that at all times

- investors are provided with true and adequate information without any misleading or exaggerated claims to investors about their capability to render certain services or their achievements in regard to services rendered to other clients,
- investors are made aware of attendant risks in members' schemes before any investment decision is made by the investors,
- copies of prospectus, memoranda and related literature is made available to investors on request,
- adequate steps are taken for fair allotment of mutual fund units and refund of application moneys without delay and within the prescribed time limits and,
- complaints from investors are fairly and expeditiously dealt with.

4.4 Members in all their communications to investors and selling agents shall

- not present a mutual fund scheme as if it were a new share issue
- not create unrealistic expectations
- not guarantee returns except as stated in the Offer Document of the scheme approved by SEBI, and in such case, the Members shall ensure that adequate resources will be made available and maintained to meet the guaranteed returns.

- convey in clear terms the market risk and the investment risks of any scheme being offered by the Members.
- not induce investors by offering benefits which are extraneous to the scheme.
- not misrepresent either by stating information in a manner calculated to mislead or by omitting to state information which is material to making an informed investment decision.

5.0 INVESTMENT PRACTICES

5.1 Members shall manage all the schemes in accordance with the fundamental investment objectives and investment policies stated in the offer documents and take investment decisions solely in the interest of the unit-holders.

5.2 Members shall not knowingly buy or sell securities for any of their schemes from or to

- any director, officer, or employee of the member
- any trustee or any director, officer, or employee of the Trustee Company

6.0 OPERATIONS

6.1 Members shall avoid conflicts of interest in managing the affairs of the schemes and shall keep the interest of all unit-holders paramount in all matters relating to the scheme.

6.2 Members or any of their directors, officers or employees shall not indulge in front running (buying or selling of any securities ahead of transaction of the fund, with access to information regarding the transaction which is not public and which is material to making an investment decision, so as to derive unfair advantage).

6.3 Members or any of their directors, officers or employees shall not indulge in self-dealing (using their position to engage in transactions with the fund by which they benefit unfairly at the expense of the fund and the unit-holders).

6.4 Members shall not engage in any act, practice or course of business in connection with the purchase or sale, directly or indirectly, of any security held or to be acquired by any scheme managed by the Members, and in purchase, sale and redemption of units of schemes managed by the Members, which is fraudulent, deceptive or manipulative.

6.5 Members shall not, in respect of any securities, be party to-

- creating a false market,
- price rigging or manipulation
- passing of price sensitive information to brokers, Members of stock exchanges and other players in the capital markets or take action which is unethical or unfair to investors.

6.6 Employees, officers and directors of the Members shall not work as agents/ brokers for selling of the schemes of the Members, except in their capacity as employees of the Member or the Trustee Company.

6.7 Members shall not make any change in the fundamental attributes of a scheme, without the prior approval of unitholders except when such change is consequent on changes in the regulations.

6.8 Members shall avoid excessive concentration of business with any broking firm, and excessive holding of units in a scheme by few persons or entities.

7.0 REPORTING PRACTICES

7.1 Members shall follow comparable and standardized valuation policies in accordance with the SEBI Mutual Fund Regulations.

7.2 Members shall follow uniform performance reporting on the basis of total return.

7.3 Members shall ensure scheme-wise segregation of cash and securities accounts.

8.0 UNFAIR COMPETITION

Members shall not make any statement or become privy to any act, practice or competition, which is likely to be harmful to the interests of other Members or is likely to place other Members in a disadvantageous position in relation to a market player or investors, while competing for investible funds.

9.0 OBSERVANCE OF STATUTES, RULES AND REGULATIONS

Members shall abide by the letter and spirit of the provisions of the Statutes, Rules and Regulations which may be applicable and relevant to the activities carried on by the Members.

10.0 ENFORCEMENT

Members shall:

- widely disseminate the AMFI Code to all persons and entities covered by it
- make observance of the Code a condition of employment
- make violation of the provisions of the code, a ground for revocation of contractual arrangement without redress and a cause for disciplinary action
- require that each officer and employee of the Member sign a statement that he/she has received and read a copy of the Code
- establish internal controls and compliance mechanisms, including assigning supervisory responsibility

- designate one person with primary responsibility for exercising compliance with power to fully investigate all possible violations and report to competent authority
- file regular reports to the Trustees on a half yearly and annual basis regarding observance of the Code and special reports as circumstances require
- maintain records of all activities and transactions for at least three years, which records shall be subject to review by the Trustees
- dedicate adequate resources to carrying out the provisions of the Code

11.0 DEFINITIONS

When used in this code, unless the context otherwise requires

(a) AMFI

"AMFI" means the Association of Mutual Funds in India

(b) Associate

"Associate" means and includes an 'associate' as defined in regulation 2(c) of SEBI (Mutual Fund) Regulations 1996.

(c) Fundamental investment policies

The "fundamental investment policies" of a scheme managed by a member means the investment objectives, policies, and terms of the scheme, that are considered fundamental attributes of the scheme and on the basis of which unitholders have invested in the scheme.

(d) Member

A "member" means the member of the Association of Mutual Funds in India.

(e) SEBI

"SEBI" means Securities and Exchange Board of India.

(f) Significant Unit holder

A "Significant Unit holder" means any entity holding 5% or more of the total corpus of any scheme managed by the member and includes all entities directly or indirectly controlled by such a unit holder.

(g) Trustee

A "trustee" means a member of the Board of Trustees or a director of the Trustee Company.

(h) Trustee Company

A “Trustee Company” is a company incorporated as a Trustee Company and set up for the purpose of managing a mutual fund.

3.6 Appendix 2: AMFI's Code of Conduct for Intermediaries of Mutual Funds

AMFI's Code of Conduct for Intermediaries of Mutual Funds

3.1 Consider investor's interest as paramount and take necessary steps to ensure that the investor's interest is protected in all circumstances.

3.2 Adhere to SEBI Mutual Fund Regulations and guidelines issued from time to time related to distributors, selling, distribution and advertising practices. Be fully conversant with the key provisions of the Scheme Information Document (SID), Statement of Additional Information (SAI) and Key Information Memorandum (KIM) as well as the operational requirements of various schemes.

3.3 Comply with SEBI guidelines / requirements issued from time to time in preparation of sales, promotional or any other literature about any schemes. Performance disclosures should also comply with the requirements specified by SEBI. Provide full and latest information of schemes to investors in the form of SAI, SID, addenda, performance reports, fact sheets, portfolio disclosures and brochures; and recommend schemes appropriate for the investor's risk profile and needs.

3.4 Highlight risk factors of each scheme, desist from misrepresentation and exaggeration and urge investors to go through SAI / SID/ KIM before deciding to make investments.

3.5 Disclose to the investors all material information including all the commissions (in the form of trail or any other mode) received for the different competing schemes of various Mutual Funds from amongst which the scheme is being recommended to the investors.

3.6 Abstain from indicating or assuring returns in any type of scheme, unless the SID is explicit in this regard.

3.7 Maintain necessary infrastructure to support the AMCs in maintaining high service standards to investors, and ensure that critical operations such as forwarding forms and cheques to AMCs/registrars and despatch of statement of account and redemption cheques to investors are done within the time frame prescribed in the SID/SAI and SEBI Mutual Fund Regulations.

3.8 Do not collude with investors in faulty business practices such as bouncing of cheques, wrong claiming of dividend/redemption cheques, splitting of applications in the schemes to circumvent regulations for any benefit, etc.

3.9 Do not undertake commission driven malpractices such as:

a. recommending inappropriate products solely because the intermediary is getting higher commissions there from.

b. encouraging over transacting and churning of Mutual Fund investments to earn higher commissions.

c. Splitting of applications to earn higher transaction charges / commissions.

3.10 Abstain from making negative statements about any AMC or scheme and ensure that comparisons, if any, are made with similar and comparable products along with complete facts.

3.11 Intermediaries shall keep themselves abreast with the developments relating to the Mutual Fund Industry as also changes in the scheme information and information on mutual fund / AMC like changes in fundamental attributes, changes in controlling interest, loads, liquidity provisions, and other material aspects and deal with the investors appropriately having regard to the up to date information.

3.12 Maintain confidentiality of all investor details, deals and transactions.

3.13 Intermediaries shall keep investor's interest and suitability to their financial needs as paramount and that extra commission or incentive should never form the basis for recommending a scheme to the investor.

3.14 Intermediaries shall not rebate commission back to investors and abstain from attracting investors through temptation of rebate/gifts etc.

3.15 To protect the investors from potential fraudulent activities, intermediary should take reasonable steps to ensure that the investor's address and contact details filled in the mutual fund application form are investor's own details, and not of any third party. Where the required information is not available in the application form, intermediary should make reasonable efforts to obtain accurate and updated information from the investor. Intermediaries should abstain from filling wrong / incorrect information or information of their own or of their employees, officials or agents as the investor's address and contact details in the application form, even if requested by the investor to do so. Intermediary should abstain from tampering in any way with the application form submitted by the investor, including inserting, deleting or modifying any information in the application form provided by the investor.

3.16 Intermediaries including the sales personnel of intermediaries engaged in sales / marketing shall obtain NISM certification and register themselves with AMFI and obtain an Employee Unique Identification Number (EUIN) from AMFI apart from AMFI Registration Number (ARN). The Intermediaries shall ensure that the employees quote the EUIN in the Application Form for investments. The NISM certification and AMFI registration shall be renewed on timely basis. Employees in other functional areas should also be encouraged to obtain the same certification.

3.17 Intermediaries shall comply with the Know Your Distributor (KYD) norms issued by AMFI.

3.18 Co-operate with and provide support to AMCs, AMFI, competent regulatory authorities, Due Diligence Agencies (as applicable) in relation to the activities of the intermediary or any regulatory requirement and matters connected thereto.

3.19 Provide all documents of its investors in terms of the Anti-Money Laundering / Combating Financing of Terrorism requirements, including KYC documents / Power of Attorney / investor's agreement(s), etc. with Intermediaries as may be required by AMCs from time to time.

3.20 Be diligent in attesting / certifying investor documents and performing In Person Verification (IPV) of investor's for the KYC process in accordance with the guidelines prescribed by AMFI / KYC Registration Agency (KRA) from time to time.

3.21 Adhere to AMFI guidelines and Code of Conduct issued from time to time related to distributors, selling, distribution and advertising practices.

3.22 Intimate the AMC and AMFI any changes in the intermediary's status, constitution, address, contact details or any other information provided at the time of obtaining AMFI Registration.

3.23 Observe high standards of ethics, integrity and fairness in all its dealings with all parties – investors, Mutual Funds/ AMCs, Registrars & Transfer Agents and other intermediaries. Render at all times high standards of service, exercise due diligence, and ensure proper care.

3.24 Intermediaries satisfying the criteria specified by SEBI for due diligence exercise, shall maintain the requisite documentation in respect of the "Advisory" or "Execution Only" services provided by them to the investors.

3.25 Intermediaries shall refund to AMCs, either by set off against future commissions or payment, all incentives of any nature, including commissions received, that are subject to claw-back as per SEBI regulations or the terms and conditions issued by respective AMC.

3.26 In respect of purchases (including switch-in's) into any fund w.e.f. January 1, 2013, in the event of any switches from Regular Plan (Broker Plan) to Direct Plan, all upfront commissions paid to distributors shall be liable to complete and / or proportionate claw-back.

3.27 Do not indulge in fraudulent or unfair trade practices of any kind while selling units of Schemes of any mutual fund. Selling of units of schemes of any mutual fund by any intermediary directly or indirectly by making false or misleading statement, concealing or omitting material facts of the scheme, concealing the associated risk factors of the schemes or not taking reasonable care to ensure suitability of the scheme to the investor will be construed as fraudulent / unfair trade practice.

Note: SID should be read in conjunction with SAI, and not in isolation.

Sample Questions

1. SEBI regulates __________.

a. Mutual Funds
b. Depositories
c. Registrar & Transfer Agents
d. All of the above

2. Investment objective defines the broad investment charter.

a. True
b. False

3. Statement of Account is to be sent to investors within ___ days of NFO closure.

a. 3
b. 5
c. 7
d. 15

4. Within ___ days of dividend declaration, warrants will have to be sent to investors.

a. 7
b. 10
c. 15
d. 30

5. Unit holders can hold their units in demat form.

a. True
b. False

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CHAPTER 4: OFFER DOCUMENT

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Offer document in a mutual fund
- Key Information Memorandum

4.1 Offer Document – NFO, SID, SAI

4.1.1 New Fund Offer (NFO)

Units in a mutual fund scheme are offered to public investors for the first time through a NFO. The offer is made through a legal document called the Offer Document. The following are a few key steps leading to the NFO:

- The AMC decides on a scheme to take to the market. This is decided on the basis of inputs from the CIO on investment objectives that would benefit investors, and inputs from the CMO on the interest in the market for the investment objectives.

- The AMC prepares the Offer Document for the NFO. This needs to be approved by the Trustees and the Board of Directors of the AMC.

    - The trustees have to give an undertaking that the scheme is a new product and not a minor modification of an existing scheme.

- The documents are filed with SEBI. The observations that SEBI makes on the Offer Document need to be incorporated. In case no modifications are suggested by SEBI within 21 days of filing the same, the AMC can make the issue in the market.

- The AMC decides on a suitable time-table for the issue, keeping in mind the market situation.

- The AMC launches its advertising and public relations campaigns to make investors aware of the NFO. These need to comply with SEBI's advertising code, which is discussed in Chapter 5.

- The AMC holds events for intermediaries and the press to make them familiar with the scheme, its unique features, benefits for investors, etc.

- The Offer Documents and Application Forms are distributed to market intermediaries, and circulated in the market, so that investors can apply in the NFO.

Three dates are relevant for the NFO of an open-ended scheme:

NFO Open Date – This is the date from which investors can invest in the NFO

NFO Close Date – This is the date upto which investors can invest in the NFO

Scheme Re-Opening Date – This is the date from which the investors can offer their units for re-purchase to the scheme (at the re-purchase price); or buy new units of the scheme (at the sale price, which is the NAV itself). The AMC announces Sale and Re-purchase prices from the Scheme Re-Opening Date.

Close-ended Schemes have an NFO Open Date and NFO Close Date. But, they have no Scheme Re-opening Date, because the scheme does not sell or re-purchase units. Investors will need to buy or sell units in the stock exchange(s) where the scheme is listed.

Under the SEBI guidelines, NFOs other than ELSS and RGESS can remain open for a maximum of 15 days. Allotment of units or refund of moneys, as the case may be, should be done within 5 business days of closure of the scheme. Further, open-ended schemes have to re-open for sale and re-purchase within 5 business days of the allotment.

4.1.2 The Role of Offer Documents

Investors get to know the details of the scheme in which they are considering investing through the Offer Document. This may be in the NFO of the scheme, or in the case of an open-ended scheme, in the continuous offer period. SEBI requires that all the information that the investor may require to make an informed investment decision should be available in the Offer Document. Information like the nature of the scheme, its investment objectives and strategy, the terms of the offer, liquidity and the services available to the investor enable an investor to make an investment decision.

Since the disclosures in the Offer Document are as prescribed by SEBI, it is a legal document that helps investors to take a balanced view on the investment. The Offer Document is the most important sources of information on the core aspects of the scheme called its fundamental attributes. The fundamental attributes of the scheme includes

- The type of scheme
  - Open-ended/ Close-ended/ Interval
  - Equity fund/Sectoral fund/Balanced fund/Income fund/Debt fund/Index fund/Any other type of fund
- Investment objective(s) of the scheme
  - Main objective- Growth/Income/Both
  - Investment pattern-The indicative break-up of the portfolio between equity, debt and money market instruments with minimum and maximum allocation to each. The fund could retain the right to alter the allocation for defensive consideration.
- Terms of the issue
  - Liquidity provisions such as listing, repurchase and redemption

- Fees and expenses charged to the scheme
- Any safety net or guarantee provided

Even post-investment, the Offer Document can be referred to, to understand the investment objectives, the various commitments made by the AMC, and how well these commitments are being adhered to.

Investors need to note that their investment is governed by the principle of *caveat emptor* i.e. let the buyer beware. An investor is presumed to have read and understood the Offer Document before investing in it. Therefore, at a future date, the investor cannot claim that he was not aware of something, which is appropriately disclosed in the Offer Document.

Mutual Fund Offer Documents have two parts:

Scheme Information Document (SID), which has details of the particular scheme

Statement of Additional Information (SAI), which has statutory information about the mutual fund, that is offering the scheme.

It stands to reason that a single SAI is relevant for all the schemes offered by a mutual fund.

In practice, SID and SAI are two separate documents, though the legal technicality is that SAI is part of the SID.

Both documents are prepared in the format prescribed by SEBI, and submitted to SEBI. The contents need to flow in the same sequence as in the prescribed format. The mutual fund is permitted to add any disclosure, which it feels, is material for the investor.

Since investors are not sophisticated experts of finance or law, the documents are prepared in simple language, and in clear, concise and easy to understand style.

While SEBI does not approve or disapprove Offer Documents, it gives its observations. The mutual fund needs to incorporate these observations in the Offer Document that is offered in the market. Thus, the Offer Documents in the market are “vetted” by SEBI, though SEBI does not formally “approve” them.

4.1.3 Contents of SID

The cover page has the name of the scheme followed by its type viz.

- Open-ended / Close-ended / Interval (the scheme structure)
- Equity / Balanced / Income / Debt / Liquid / ETF (the expected nature of scheme portfolio)

It also mentions the face value of the Units being offered, relevant NFO dates (opening, closing, re-opening), date of SID, name of the mutual fund, and name & contact information of the AMC and trustee company. Finally, the cover page has the following standard clauses, which every investor ought to note:

> "The particulars of the Scheme have been prepared in accordance with the Securities and Exchange Board of India (Mutual Funds) Regulations 1996, (herein after referred to as 'SEBI (MF) Regulations') as amended till date, and filed with SEBI, along with a Due Diligence Certificate from the AMC. The units being offered for public subscription have not been approved or recommended by SEBI nor has SEBI certified the accuracy or adequacy of the Scheme Information Document.
>
> The Scheme Information Document sets forth concisely the information about the scheme that a prospective investor ought to know before investing. Before investing, investors should also ascertain about any further changes to this Scheme Information Document after the date of this Document from the Mutual Fund / Investor Service Centres / Website / Distributors or Brokers.
>
> The investors are advised to refer to the Statement of Additional Information (SAI) for details of ________ Mutual Fund, Tax and Legal issues and general information on www.___________. (Website address)
>
> SAI is incorporated by reference (is legally a part of the Scheme Information Document). For a free copy of the current SAI, please contact your nearest Investor Service Centre or log on to our website.
>
> The Scheme Information Document should be read in conjunction with the SAI and not in isolation".

- Table of Contents
- Highlights
- Introduction
  - Risk Factors
    - Standard
    - Scheme-specific
  - Provisions regarding minimum no. of investors in the scheme
  - Any other special considerations
  - Definitions
  - Due Diligence Certificate (issued by the AMC)
- Information about the scheme

- Units and Offer
- Fees & Expenses
- Rights of Unit-holders
- Penalties, Litigation etc.

The SID mentions the proposed asset allocation mix and nature of investments in which the moneys of the scheme will be deployed. However, names of specific securities where the scheme will invest are obviously not mentioned. Learn about the contents of the SID in detail in the SID format given in Appendix 3.

Draft SID is a public document, available for viewing in SEBI's website (www.sebi.gov.in) for 21 working days. The final SID (after incorporating SEBI's observations) has to be hosted on AMFI's website (www.amfiindia.com) two days before the issue opens.

Every mutual fund, on its website, provides for download of the SID for all its current schemes.

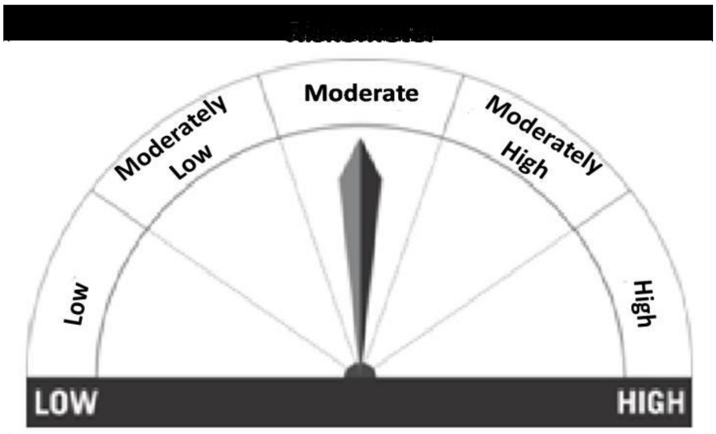
SEBI has also instituted a system of labelling mutual fund products to enable investors to easily assess its suitability to their investment objective and preferences for risk. The label will cover the following parameters:

- Nature of scheme such as to create wealth or provide regular income in an indicative time horizon (short/ medium/ long term). For example, "The product is suitable for investors who are seeking long term capital appreciation", will be the statement for an equity fund.
- A brief about the investment objective (in a single line sentence) followed by kind of product in which investor is investing (Equity/Debt). For example, "A Balanced fund aiming for long term capital appreciation and current income by investing in equity as well as fixed income securities", will be the description of investment objective for a balanced fund.
- A pictoral representation of the risk to the principal invested in a mutual fund product will be depicted using a 'Riskometer'. The picto-meter will categorize the risk in the scheme at one of five levels of risk, as shown in the table below. There will also be a written statement of the risk to the principal below the 'Riskometer'.

Level of Risk	Definition	Example
Low	Principal at low risk	Liquid or Money Market Fund
Moderately Low	Principal at moderately low risk	Fixed Maturity Plans/Capital Protection Oriented Scheme

Moderate	Principal at moderate risk	Short Term Income Fund/Conservative Monthly Income Plans
Moderately High	Principal at moderately high risk	Index Fund/Balanced Fund/Equity Dividend Yield Fund
High	Principal of high risk	Sector Fund/Equity Focussed Fund

RISKOMETER



Investors understand that their principal will be at moderate risk.

(Source: SEBI)

- A recommendation that investors should consult their financial advisor if they are in doubt about the suitability of the product for their investment needs.

The product labels are to be disclosed in:

- Front page of initial offering application forms, Key Information Memorandum (KIM) and Scheme Information Documents (SIDs).

  The product label is to be placed in proximity to the caption of the scheme and shall be prominently visible.

- Common application form – along with the information about the scheme.

  The product label is to be placed in proximity to the caption of the scheme and shall be prominently visible.

- Scheme advertisements – placed in manner so as to be prominently visible to investors.

4.1.4 Update of SID

Regular

If a scheme is launched in the first 6 months of the financial year (say, April 2014), then the first update of the SID is due within 3 months of the end of the financial year (i.e. by June 2015).

If a scheme is launched in the second 6 months of the financial year (say, October 2014), then the first update of the SID is due within 3 months of the end of the next financial year (i.e. by June 30, 2016).

Thereafter, SID is to be updated every year.

Need-based

In case of change in the fundamental attributes, the SID has to be updated immediately after the lapse of the time period given to existing investors to exit the scheme.

In case of any other change-

- It will be printed on a separate piece of paper (addendum) and distributed along with the SID, until the SID is updated.
- If a change is superseded by a further change (for instance, change in load), then addenda are not required for the superseded change i.e. addenda is only required to disclose the latest position.
- The change is to be advertised in an English newspaper having nation-wide circulation, and in a newspaper of the language of the region where the head office of the mutual fund is located.
- The change is to be mentioned in the website of the mutual fund.

4.1.5 Contents of SAI

- Information about Sponsors, AMC and Trustee Company (includes contact information, shareholding pattern, responsibilities, names of directors and their contact information, profiles of key personnel), and contact information of service providers {Custodian, Registrar & Transfer Agent, Statutory Auditor, Fund Accountant (if outsourced) and Collecting Bankers}
- Condensed financial information (for schemes launched in last 3 financial years)
- How to apply
- Rights of Unit-holders

- Investment Valuation Norms
- Tax, Legal & General Information (including investor grievance redressal mechanism, and data on number of complaints received and cleared, and opening and closing number of complaints for previous 3 financial years and for the current year to-date).

Every mutual fund, in its website, provides for download of its SAI. Investors have a right to ask for a printed copy of the SAI.

Through AMFI website (www.amfiindia.com) investors can access the SAI of all the mutual funds. Examinees are advised to study the SAI for any mutual fund, to get a better understanding of the disclosures.

4.1.6 Update of SAI

Regular update is to be done by the end of 3 months of every financial year.

Material changes have to be updated on an ongoing basis and uploaded on the websites of the mutual fund and AMFI.

4.2 Key Information Memorandum

4.2.1 Role of KIM

KIM is essentially a summary of the SID and SAI. It contains the key points of the offer document that is essential for the investor to know to make a decision on the suitability of the investment for their needs. It is more easily and widely distributed in the market. As per SEBI regulations, every application form is to be accompanied by the KIM.

4.2.2 Contents of KIM

Some of the key items are as follows:

- Name of the AMC, mutual fund, Trustee, Fund Manager and scheme
- Dates of Issue Opening, Issue Closing & Re-opening for Sale and Re-purchase
- Plans and Options under the scheme
- Risk Profile of Scheme
- Price at which Units are being issued and minimum amount / units for initial purchase, additional purchase and re-purchase
- Benchmark
- Dividend Policy

- Performance of scheme and benchmark over last 1 year, 3 years, 5 years and since inception.
- Loads and expenses
- Contact information of Registrar for taking up investor grievances

The prescribed KIM format is in Appendix 4.

4.2.3 Update of KIM

KIM is to be updated at least once a year.

As in the case of SID, KIM is to be revised in the case of change in fundamental attributes. Other changes can be disclosed through addenda attached to the KIM.

4.3 Appendix 3: Format of Scheme Information Document (SID)

SCHEME INFORMATION DOCUMENT

NAME OF THE SCHEME
(Type of Scheme - Open /Closed / Interval/ Equity/ Balanced/ Income/ Debt/ Liquid/ETF etc.)

Offer of Units of Rs. -- each for cash (subject to applicable load) during the New Fund Offer and Continuous offer for Units at NAV based prices

New Fund Offer Opens on: _______
New Fund Offer Closes on: _______
Scheme re-opens on: __________

Name of Mutual Fund :
Name of Asset Management Company :
Name of Trustee Company :
Addresses, Website of the entities :

The particulars of the Scheme have been prepared in accordance with the Securities and Exchange Board of India (Mutual Funds) Regulations 1996, (herein after referred to as SEBI (MF) Regulations) as amended till date, and filed with SEBI, along with a Due Diligence Certificate from the AMC. The units being offered for public subscription have not been approved or recommended by SEBI nor has SEBI certified the accuracy or adequacy of the Scheme Information Document.

The Scheme Information Document sets forth concisely the information about the scheme that a prospective investor ought to know before investing. Before investing, investors should also ascertain about any further changes to this Scheme Information Document after the date of this Document from the Mutual Fund / Investor Service Centres / Website / Distributors or Brokers.

The investors are advised to refer to the Statement of Additional Information (SAI) for details of ________ Mutual Fund, Tax and Legal issues and general information on www.__________. *(Website address).*

SAI is incorporated by reference (is legally a part of the Scheme Information Document). For a free copy of the current SAI, please contact your nearest

Investor Service Centre or log on to our website.

The Scheme Information Document should be read in conjunction with the SAI and not in isolation.

This Scheme Information Document is dated ________.

Note:
The wording in italics is explanatory commentary/instructions.
The words in Arial font are the text to be used in the Scheme Information Document, as applicable.

Instructions:

i. A Mutual Fund is free to add any other disclosure, which in the opinion of the Trustees of the Mutual Fund (Trustees) or the Asset Management Company (AMC) is material for the investor, provided that such information is not presented in an incomplete, inaccurate or misleading manner. Care should be taken to ensure that inclusion of such information does not, by virtue of its nature, or manner of presentation, obscure or impede understanding of any information that is required to be included under the Scheme Information Document.

ii. Since investors who rely on the Scheme Information Document may not be sophisticated in legal or financial matters, care should therefore be taken to present the information in the Scheme Information Document in simple language and in a clear, concise and easily understandable manner.

iii. The scheme shall not have a name or title which may be deceptive or misleading. Scheme's name should be consistent with its statement of investment policy.

iv. The type of the scheme would mean whether the scheme is a growth scheme, income scheme, balanced scheme etc. and whether the scheme is open-ended, close-ended, an interval fund etc.

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HIGHLIGHTS/SUMMARY OF THE SCHEME - *This section shall include the following:*

- Investment objective
- Liquidity
- Benchmark

- Transparency/NAV Disclosure
- Loads
- Minimum Application Amount

(Highlights/summary of the scheme, irrespective of whether they appear on the Cover Page or not, shall make a specific disclosure in case of assured return schemes regarding the guarantee given either by the AMC or by the Sponsor to distribute income at the assured rate, and to redeem the capital invested, to the unit holder. This statement shall be in bold, legible fonts.)

I. INTRODUCTION

A. RISK FACTORS

Standard Risk Factors:

• Investment in Mutual Fund Units involves investment risks such as trading volumes, settlement risk, liquidity risk, default risk including the possible loss of principal.

• As the price / value / interest rates of the securities in which the scheme invests fluctuates, the value of your investment in the scheme may go up or down *(Mutual Funds may also provide factors affecting capital market in general and not limited to the aforesaid)*

• Past performance of the Sponsor/AMC/Mutual Fund does not guarantee future performance of the scheme.

• The name of the scheme does not in any manner indicate either the quality of the scheme or its future prospects and returns.

• The sponsor is not responsible or liable for any loss resulting from the operation of the scheme beyond the initial contribution of _____ made by it towards setting up the Fund.

• The present scheme is the first scheme being launched under its management. *(Applicable, if the AMC has no previous experience in managing a Mutual Fund)*

• The present scheme is not a guaranteed or assured return scheme *(applicable to all schemes except assured return schemes)*

Scheme Specific Risk Factors

• **Schemes investing in Equities** - *Describe briefly risks associated with investment in equity*

• **Schemes investing in Bonds** – *Describe briefly risks associated with fixed income products like Credit Risk, Prepayment Risk, Liquidity Risk etc.*

• **Risks associated with Investing in Foreign Securities** - *(if the scheme invests in these instruments)*

• **Risks associated with Investing in Derivatives** - *(if the scheme invests in these instruments)*

• **Risks associated with Investing in Securitised Debt** - *(if the scheme invests in these instruments)*

• **Risks associated with Short Selling and Securities Lending** - *(if the scheme intends to participate in short selling and securities lending).*

B. REQUIREMENT OF MINIMUM INVESTORS IN THE SCHEME

(Applicability for an open-ended scheme)

The Scheme/Plan shall have a minimum of 20 investors and no single investor shall account for more than 25% of the corpus of the Scheme/Plan(s). However, if such limit is breached during the NFO of the Scheme, the Fund will endeavour to ensure that within a period of three months or the end of the succeeding calendar quarter from the close of the NFO of the Scheme, whichever is earlier, the Scheme complies with these two conditions. In case the Scheme / Plan(s) does not have a minimum of 20 investors in the stipulated period, the provisions of Regulation 39(2)(c) of the SEBI (MF) Regulations would become applicable automatically without any reference from SEBI and accordingly the Scheme / Plan(s) shall be wound up and the units would be redeemed at applicable NAV. The two conditions mentioned above shall also be complied within each subsequent calendar quarter thereafter, on an average basis, as specified by SEBI. If there is a breach of the 25% limit by any investor over the quarter, a rebalancing period of one month would be allowed and thereafter the investor who is in breach of the rule shall be given 15 days' notice to redeem his exposure over the 25 % limit. Failure on the part of the said investor to redeem his exposure over the 25 % limit within the aforesaid 15 days would lead to automatic redemption by the Mutual Fund on the applicable Net Asset Value on the 15th day of the notice period. The Fund shall adhere to the requirements prescribed by SEBI from time to time in this regard.

(Applicability for a Close ended scheme / Interval scheme)

The Scheme(s) and individual Plan(s) under the Scheme(s) shall have a minimum of 20 investors and no single investor shall account for more than 25% of the corpus of the Scheme(s)/Plan(s). These conditions will be complied with immediately after the close of the NFO itself i.e. at the time of allotment. In case of non-fulfilment with the condition of minimum 20 investors, the Scheme(s)/Plan(s) shall be wound up in accordance with Regulation 39 (2) (c) of SEBI (MF) Regulations automatically without any reference from SEBI. In case of non-fulfilment with the condition of 25% holding by a single investor on the date of allotment, the application to the extent of exposure in excess of the stipulated 25% limit would be liable to be rejected and the allotment would be effective only to the extent of 25%

of the corpus collected. Consequently, such exposure over 25% limits will lead to refund within 6 weeks of the date of closure of the New Fund Offer.

For interval scheme the aforesaid provision will be applicable at the end of NFO and specified transaction period.

C. SPECIAL CONSIDERATIONS, *if any*

D. DEFINITIONS - *All terms used in the Scheme Information Document shall be defined in this Section.*

Instructions:
i. Language and terminology used in the Scheme Information Document shall be as provided in the Regulations. Any new term if used shall be clearly defined.
ii. All terms shall be used uniformly throughout the text of the Scheme Information Document e.g. the terms 'sale price' and 'repurchase price' shall be used uniformly to indicate 'offer price' and 'bid price' of units.
iii. The term 'scheme' shall be used uniformly to indicate the different schemes of a Mutual Fund.

E. DUE DILIGENCE BY THE ASSET MANAGEMENT COMPANY

The Asset Management Company shall confirm that a Due Diligence Certificate duly signed by the Compliance Officer/Chief Executive Officer / Managing Director / Whole time Director/Executive Director of the Asset Management Company has been submitted to SEBI, which reads as follows:

It is confirmed that:
(i) the draft Scheme Information Document forwarded to SEBI is in accordance with the SEBI (Mutual Funds) Regulations, 1996 and the guidelines and directives issued by SEBI from time to time.
(ii) all legal requirements connected with the launching of the scheme as also the guidelines, instructions, etc., issued by the Government and any other competent authority in this behalf, have been duly complied with.
(iii) the disclosures made in the Scheme Information Document are true, fair and adequate to enable the investors to make a well informed decision regarding investment in the proposed scheme.
(iv) the intermediaries named in the Scheme Information Document and Statement of Additional Information are registered with SEBI and their registration is valid, as on date.

II. INFORMATION ABOUT THE SCHEME

A. TYPE OF THE SCHEME - *(open/close/interval, Equity/Debt/Income/Liquid/Balanced/ETF etc.)*

B. WHAT IS THE INVESTMENT OBJECTIVE OF THE SCHEME?

The scheme's investment objective and policies (including the types of securities in which it will invest) shall be clearly and concisely stated in the Scheme Information Document so that they may be readily understood by the unit holder/investor.

C.HOW WILL THE SCHEME ALLOCATE ITS ASSETS?

This includes asset allocation table giving the broad classification of assets and indicative exposure level in percentage terms specifying the risk profile. If the scheme's name implies that it will invest primarily in a particular type of security, or in a certain industry or industries, the scheme shall have an investment policy that requires that, under normal circumstances, at least 65 percent of the value of its total assets be invested in the indicated type of security or industry. The asset allocation should be consistent with the investment objective of the scheme.

Instruments	Indicative allocations (% of total assets)		Risk Profile
	Maximum	Minimum	High/Medium/Low

Percentage of investment in foreign securities, derivatives, stock lending, securitized debt etc. to be indicated.

D.WHERE WILL THE SCHEME INVEST?

This includes a brief narration on the types of instruments in which the scheme will invest and the concerned regulations and limits applicable shall also be mentioned.

Investment in overseas securities shall be made in accordance with the requirements stipulated by SEBI and RBI from time to time.

Brief narration on the various derivative products specifying (i) the instruments to be used (ii) the applicable limits.

E.WHAT ARE THE INVESTMENT STRATEGIES?

Information about investment approach and risk control should be included in simple terms. In case the scheme proposes to invest in derivatives, disclosures on the various strategies to be adopted by the fund manager shall be made.

In case of assured return schemes, the Scheme Information Document shall disclose:

1. how many schemes have assured returns, their number and corpus size;
2. the justification as to how the net worth and liquidity position of the guarantor would be adequate to meet the shortfall in these schemes;
3. details of the schemes which did not pay assured returns in the past and how the shortfall was met.

Further, Portfolio turnover policy, particularly for equity oriented schemes shall also be disclosed. In discussing the investment strategies, the scheme shall briefly discuss in the Scheme Information Document the probable effect of such strategies on the rate of the total portfolio turnover of the scheme, if such effects are significant and also other consequences which will result from the higher portfolio turnover rate e.g. higher brokerage and transaction cost.

F: FUNDAMENTAL ATTRIBUTES

Following are the Fundamental Attributes of the scheme, in terms of Regulation 18 (15A) of the SEBI (MF) Regulations:

(i) <u>Type of a scheme</u>
- o Open ended/Close ended/Interval scheme
- o Sectoral Fund/Equity Fund/Balance Fund/Income Fund/Index Fund/Any other type of Fund

(ii) <u>Investment Objective</u>
- o Main Objective - Growth/Income/Both.
- o Investment pattern - The tentative Equity/Debt/Money Market portfolio break-up with minimum and maximum asset allocation, while retaining the option to alter the asset allocation for a short term period on defensive considerations.

(iii) <u>Terms of Issue</u>
- o Liquidity provisions such as listing, repurchase, redemption.
- o Aggregate fees and expenses charged to the scheme.
- o Any safety net or guarantee provided.

In accordance with Regulation 18(15A) of the SEBI (MF) Regulations, the Trustees shall ensure that no change in the fundamental attributes of the Scheme(s) and the Plan(s) / Option(s) thereunder or the trust or fee and expenses payable or any other change which would modify the Scheme(s) and the Plan(s) / Option(s) thereunder and affect the interests of Unitholders is carried out unless:

• A written communication about the proposed change is sent to each Unit-holder and an advertisement is given in one English daily newspaper having nationwide circulation as well as in a newspaper published in the language of the region where the Head Office of the mutual fund is situated; and
• The Unitholders are given an option for a period of 30 days to exit at the prevailing Net Asset Value without any exit load.

Instruction
It shall be ensured that the advertisement is published and written communication is dispatched appropriately in advance of the commencement of 30 days period.

G. HOW WILL THE SCHEME BENCHMARK ITS PERFORMANCE?

The name and the justification (specific to the scheme objective) for the use of benchmark index with which the performance of the scheme can be compared with.

H. WHO MANAGES THE SCHEME?

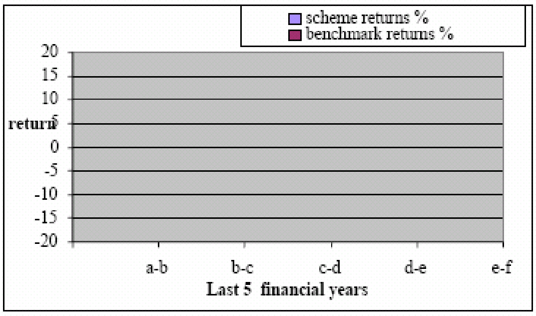
Name, age, qualification and experience of the fund manager to the scheme to be disclosed. The experience of the fund manager should include last 10 years of experience and also the name of other schemes under his /her management.

I. WHAT ARE THE INVESTMENT RESTRICTIONS?
All the investment restrictions as contained in the Seventh Schedule to SEBI (Mutual Funds) Regulations, 1996 and applicable to the scheme should be incorporated. Further in case the fund follows any internal norms vis-à-vis limiting exposure to a particular scrip or sector, etc. apart from the aforementioned investment restrictions the same needs to be disclosed.

In case of equity schemes disclose only equity related investment restriction though the scheme would be investing a portion of the assets in bonds for liquidity or for other purposes. In case of fixed income/debt schemes disclose only the investment restriction applicable to bonds. In case of balanced schemes all investment restrictions are to be disclosed.

J. HOW HAS THE SCHEME PERFORMED?

[In case of a new scheme, this is not applicable hence give the statement-"This scheme is a new scheme and does not have any performance track record"]	Compounded Annualised Returns	Scheme Returns %	Benchmark Returns %
Or	Returns for the last 1 year		
[In case of a scheme in existence, the return figures shall be given for that scheme only, as per the For a scheme which is in existence for more than 1 year, the returns given will be Compounded Annualised Returns and for scheme which is in existence for less than 1 year, the returns would be absolute returns since inception.	Returns for the last 3 years		
	Returns for the last 5 years		
	Returns since inception		
Absolute returns for each financial year for the last 5 years shall be represented by means of a bar diagram as per the adjacent format.]	Absolute Returns for each financial year for the last 5 years		



III. UNITS AND OFFER

This section provides details you need to know for investing in the scheme.

III. UNITS AND OFFER

This section outlines details for investing in the scheme.

A. NEW FUND OFFER (NFO)

New Fund Offer Period This is the period during which a new scheme sells its units to the investors.	NFO opens on: NFO closes on: *(mention provision, if any, for extension and/or early closure)*
New Fund Offer Price: This is the price per unit that the investors have to pay to invest during the NFO.	
Minimum Amount for Application in the NFO	
Minimum Target amount	Rs. ____________

This is the minimum amount required to operate the scheme and if this is not collected during the NFO period, then all the investors would be refunded the amount invested without any return. However, if AMC fails to refund the amount within 6 weeks, interest as specified by SEBI (currently 15% p.a.) will be paid to the investors from the expiry of six weeks from the date of closure of the subscription period.	
Maximum Amount to be raised (if any) This is the maximum amount which can be collected during the NFO period, as decided by the AMC.	Rs. ____________
Plans / Options offered	Dividend, Growth, Bonus etc.
Dividend Policy	
Allotment	*Mention, the procedure for allotment and dispatch of account statements/unit certificates. Indicate the time period.*
Applications Supported by Blocked Amount (ASBA) facility	ASBA facility will be provided to the investors subscribing to NFO of the Scheme. It shall co-exist with the existing process, wherein cheques/ demand drafts are used as a mode of payment.
Refund	If application is rejected, full amount will be refunded within 6 weeks of closure of NFO. If refunded later than 6 weeks, interest @ 15%p.a. for delay period will be paid and charged to the AMC.
Who can invest This is an indicative list and you are requested to consult your financial advisor to ascertain whether the scheme is suitable to your risk profile.	*Mention category of applicants, who are eligible to invest in the scheme. The AMC may also want to mention if there are any specific categories who are prohibited from investing in the scheme.*

Where can you submit the filled up applications.	*Provide name, address and contact no. Of Registrar and Transfer Agent (R&T), email id of R&T, website address of R&T, official points of acceptance, collecting banker details etc. on back cover page.*
How to Apply	Please refer to the SAI and Application form for the instructions.
Listing	*Mention, if applicable, the name of the Stock Exchange and the time frame by which the listing will be done.*
Special Products / facilities available during the NFO	*Briefly describe the facilities/products available.* *Facilities like:* *Systematic Investment Plan* *Systematic Transfer Plan* *Systematic Withdrawal Plan*
The policy regarding reissue of repurchased units, including the maximum extent, the manner of reissue, the entity (the scheme or the AMC) involved in the same.	
Restrictions, if any, on the right to freely retain or dispose of units being offered.	

B. ONGOING OFFER DETAILS

Ongoing Offer Period This is the date from which the scheme will reopen for subscriptions/redemptions after the closure of the NFO period.	W.e.f. ____ (date) or within ____ days of the date of Closure of the NFO.

Ongoing price for subscription/purchase)/ switch-in (from other schemes/plans of the mutual fund) by investors. This is the price you need to pay for purchase/switch-in. *Example: If the applicable NAV is Rs. 10, entry load is 2% then sales price will be: Rs. 10* (1+0.02) = Rs. 10.20*	At the applicable NAV subject to prevailing entry load
Ongoing price for redemption (sale) /switch outs (to other schemes/plans of the Mutual Fund) by investors. This is the price you will receive for redemptions/switch outs. *Example: If the applicable NAV is Rs. 10, exit load is 2% then redemption price will be:* *Rs. 10* (1-0.02) = Rs. 9.80*	At the applicable NAV, subject to prevailing exit load.
Cut off timing for subscriptions/ redemptions/ switches This is the time before which your application (complete in all respects) should reach the official points of acceptance.	
Where can the applications for purchase/redemption switches be submitted?	*Provide the details of official points of acceptance, collecting banker details etc. on back cover page.*
Minimum amount for purchase/redemption/switches	
Minimum balance to be maintained and consequences of non-maintenance.	
Special Products available	*Systematic Investment Plan* *Systematic Transfer Plan* *Systematic Withdrawal Plan*
Accounts Statements	

	The asset management company shall ensure that consolidated account statement for each calendar month is issued, on or before tenth day of succeeding month, detailing all the transactions and holding at the end of the month including transaction charges paid to the distributor, across all schemes of all mutual funds, to all the investors in whose folios transaction has taken place during that month: Provided that the asset management company shall ensure that a consolidated account statement every half yearly (September/ March) is issued, on or before tenth day of succeeding month, detailing holding at the end of the six month, across all schemes of all mutual funds, to all such investors in whose folios no transaction has taken place during that period. Provided further that the asset management company shall identify common investor across fund houses by their permanent account number for the purposes of sending consolidated account statement. Account Statements for investors holding demat accounts: Subsequent account statement may be obtained from the depository participants with whom the investor holds the DP account. The asset management company shall issue units in dematerialized form to a unit-holder of the Scheme within two working days of the receipt of request from the unit-holder.

Dividend	The dividend warrants shall be dispatched to the unitholders within 30 days of the date of declaration of the dividend. In the event of failure to dispatch dividend within the stipulated 30 day period, the AMC shall be liable to pay interest @ 15% per annum to the Unit-holders. Investors residing in such places where Electronic Clearing Facility is available will have the option of receiving their dividend directly into their specified bank account through ECS. In such a case, only an advice of such a credit will be mailed to the investors.
Redemption	The redemption or repurchase proceeds shall be dispatched to the unitholders within 10 working days from the date of redemption or repurchase.
Delay in payment of redemption / repurchase proceeds	The Asset Management Company shall be liable to pay interest to the unitholders at such rate as may be specified by SEBI for the period of such delay (presently @ 15% per annum).

C. PERIODIC DISCLOSURES

Net Asset Value This is the value per unit of the scheme on a particular day. You can ascertain the value of your investments by multiplying the NAV with your unit balance.	The Mutual Fund shall declare the Net asset value of the scheme on every business day on AMFI's website www.amfiindia.com (*time limit for uploading NAV as per applicable guidelines*) and also on their website. NAV will be published in 2 newspapers as prescribed under SEBI (Mutual Funds) Regulations, 1996. *In case of Fund of Fund and investments in foreign securities, the applicable NAV disclosure policy may be indicated.*

Half yearly Disclosures: Portfolio / Financial Results This is a list of securities where the corpus of the scheme is currently invested. The market value of these investments is also stated in portfolio disclosures.	*The mutual fund shall publish a complete statement of the scheme portfolio and the unaudited financial results, within one month from the close of each half year (i.e. 31st March and 30th September), by way of an advertisement at least, in one National English daily and one regional newspaper in the language of the region where the head office of the mutual fund is located.* *The mutual fund may opt to send the portfolio to all unit holders in lieu of the advertisement (if applicable).*
Half Yearly Results	*The mutual fund and Asset Management Company shall before the expiry of one month from the close of each half year that is on 31st March and on 30th September, publish its unaudited financial results in one national English daily newspaper and in a regional newspaper published in the language of the region where the Head Office of the mutual fund is situated.* *Mutual funds/AMCs shall make half yearly disclosures of their unaudited financial results on their respective website in a user-friendly and downloadable format.*
Monthly disclosures[3]	*Mutual funds/AMCs shall disclose portfolio (along with ISIN) as on the last day of the month for all their schemes on their respective website on or before the tenth day of the succeeding month in a user-friendly and downloadable format (preferably in a spreadsheet)* *The format for monthly portfolio disclosure shall be same as that of half yearly portfolio disclosures.*

[3]SEBI circular no. SEBI/IMD/CIR No. 15/157701/2009 dated March 19, 2009 has been withdrawn.

	Mutual funds/AMCs may disclose additional information (such as ratios, etc.) subject to compliance with the Advertisement Code
Annual Report	*Scheme wise Annual Report or an abridged summary thereof shall be mailed to all unitholders within six months from the date of closure of the relevant accounts year i.e. 31st March each year.* Mailing of Annual Report or Abridged Summary: The scheme wise annual report or an abridged summary thereof hereinafter shall be sent by AMCs as under:
	• only by e-mail to the Unit holders whose e-mail address is available • in physical form to the Unit holders whose e-mail address is not available with the Fund and/or to those Unit holders who have opted / requested for the same • A physical copy of the scheme wise annual report or abridged summary thereof shall be made available to the investors. Additionally, a link of the scheme wise annual report and abridged summary thereof shall be displayed on the website
Associate Transactions	Please refer to Statement of Additional Information (SAI).

<table>
<tr><td rowspan="6">Taxation

The information is provided for general information only. However, in view of the individual nature of the implications, each investor is advised to consult his or her own tax advisors / authorized dealers with respect to the specific amount of tax and other implications arising out of his or her participation in the schemes. (mention the tax rates as per the applicable tax laws)</td><td></td><td></td><td></td></tr>
<tr><td></td><td>Resident Investors</td><td>Mutual Fund</td></tr>
<tr><td><u>Equity Fund</u>
Tax on Dividend</td><td></td><td></td></tr>
<tr><td>Capital Gains:
Long Term
Short Term</td><td></td><td></td></tr>
<tr><td colspan="3">Equity scheme will also attract securities transaction tax (STT) at applicable rates.</td></tr>
<tr><td colspan="3">For further details on taxation please refer to the clause on Taxation in the SAI</td></tr>
<tr><td>Investor services</td><td colspan="3">Name, address and telephone number and e-mail of the contact person/grievances officer who would take care of investor queries and complaints.</td></tr>
</table>

D. COMPUTATION OF NAV

Describe briefly the policies of the Mutual Fund with regard computation of NAV of the scheme in accordance with SEBI (Mutual Funds) Regulations, 1996.

Rounding off policy for NAV as per the applicable guidelines shall be disclosed.

Policy on computation of NAV in case of investment in foreign securities shall be disclosed.

IV. FEES AND EXPENSES

This section outlines the expenses that will be charged to the schemes.

A. NEW FUND OFFER (NFO) EXPENSES

These expenses are incurred for the purpose of various activities related to the NFO like sales and distribution fees paid marketing and advertising, registrar expenses, printing and stationary, bank charges etc. *Details of source for meeting these expenses may be disclosed.*

B. ANNUAL SCHEME RECURRING EXPENSES

These are the fees and expenses for operating the scheme. These expenses include Investment Management and Advisory Fee charged by the AMC, Registrar and Transfer Agents' fee, marketing and selling costs etc. as given in the table below:

The AMC has estimated that upto _____ % of the weekly average net assets of the scheme will be charged to the scheme as expenses (*Give slab wise break up depending on the assets under management. Give plan/option wise break up if the expense structures are different*). For the actual current expenses being charged, the investor should refer to the website of the mutual fund.

Particulars	% of Net Assets	
	Retail Plan (the name of the plan as applicable)	*Institutional Plan (the name of the plan as applicable)*
Investment Management & Advisory Fee		
Custodial Fees		
Registrar & Transfer Agent Fees including cost related to providing accounts statement, dividend/redemption cheques/warrants etc.		
Marketing & Selling Expenses including Agents Commission and statutory advertisement		
Brokerage & Transaction Cost pertaining to the distribution of units		
Audit Fees / Fees and expenses of trustees		
Costs related to investor communications		
Costs of fund transfer from location to location		
Other Expenses*		

Total Recurring Expenses		

(To be specified as permitted under the Regulation 52 of SEBI (MF) Regulations)*

These estimates have been made in good faith as per the information available to the Investment Manager based on past experience and are subject to change inter-se. Types of expenses charged shall be as per the SEBI (MF) Regulations. *(The regulatory limits on Annual Recurring Expenses and Investment Management & Advisory fees in terms of Regulation 52 shall be disclosed).*

The mutual fund would update the current expense ratios on the website within two working days mentioning the effective date of the change.

C. LOAD STRUCTURE

Load is an amount which is paid by the investor to subscribe to the units or to redeem the units from the scheme. This amount is used by the AMC to pay commissions to the distributor and to take care of other marketing and selling expenses. Load amounts are variable and are subject to change from time to time. For the current applicable structure, please refer to the website of the AMC (www.-----) or may call at (toll free no.) or your distributor.

Type of Load	Load chargeable (as %age of NAV)
Entry	
Exit *	

** The load may be applicable on other types of transactions such as Dividend Reinvestment, Switch in/out, SIP/SWP/STP (which shall be disclosed in the table above as applicable)*

Load exemptions, if any:

Bonus units and units issued on reinvestment of dividends shall not be subject to entry and exit load.
The upfront commission on investment, if any, shall be paid to the ARN Holder directly by the investor, based on the investor’s assessment of various factors including service rendered by the ARN Holder.

The exit load charged, if any, after the commencement of the SEBI (Mutual Funds) (Second Amendment) Regulations, 2012, shall be credited to the scheme. Service tax on exit load shall be paid out of the exit load proceeds and exit load net of service tax shall be credited to the scheme.
The investor is requested to check the prevailing load structure of the scheme before investing.

For any change in load structure AMC will issue an addendum and display it on the website/Investor Service Centres.

Note: Wherever quantitative discounts are involved the following shall be disclosed – The Mutual Fund may charge the load within the stipulated limit of 7% and without any discrimination to any specific group of unit holders. However, any change at a later stage shall not affect the existing unit holders adversely.

[Please note that the regulations regarding load have undergone significant change since the standard format was prescribed. As per current policy, the load is not available for meeting selling expenses. The load amount needs to be credited to the scheme i.e. it goes to the benefit of investors in the scheme]

D. WAIVER OF LOAD FOR DIRECT APPLICATIONS

Disclose detailed procedure for direct applications as per the applicable SEBI guidelines in order to provide the waiver of load to the investors.

V. RIGHTS OF UNITHOLDERS

Please refer to SAI for details.

VI. PENALTIES, PENDING LITIGATION OR PROCEEDINGS, FINDINGS OF INSPECTIONS OR INVESTIGATIONS FOR WHICH ACTION MAY HAVE BEEN TAKEN OR IS IN THE PROCESS OF BEING TAKEN BY ANY REGULATORY AUTHORITY

This section shall contain the details of penalties, pending litigation, and action taken by SEBI and other regulatory and Govt. Agencies.

1. All disclosures regarding penalties and action(s) taken against foreign Sponsor(s) may be limited to the jurisdiction of the country where the principal activities (in terms of income / revenue) of the Sponsor(s) are carried out or where the headquarters of the Sponsor(s) is situated. Further, only top 10 monetary penalties during the last three years shall be disclosed.

2. In case of Indian Sponsor(s), details of all monetary penalties imposed and/ or action taken during the last three years or pending with any financial regulatory body or governmental authority, against Sponsor(s) and/ or the AMC and/ or the Board of Trustees /Trustee Company; for irregularities or for violations in the financial services sector, or for defaults with respect to shareholders or debenture holders and depositors, or for economic offences, or for violation of securities law. Details of settlement, if any, arrived at with the aforesaid authorities during the last three years shall also be disclosed.

3. Details of all enforcement actions taken by SEBI in the last three years and/ or pending with SEBI for the violation of SEBI Act, 1992 and Rules and Regulations framed there under including *debarment and/ or suspension and/ or cancellation and/ or imposition of monetary penalty/adjudication/enquiry proceedings, if any, to which the Sponsor(s) and/ or the AMC and/ or the Board of Trustees /Trustee Company and/ or any of the directors and/ or key personnel (especially the fund managers) of the AMC and Trustee Company were/ are a party. The details of the violation shall also be disclosed.*

4. Any pending material civil or criminal litigation incidental to the business of the Mutual Fund to which the Sponsor(s) and/ or the AMC and/ or the Board of Trustees /Trustee Company and/ or any of the directors and/ or key personnel are a party should also be disclosed separately.

5. Any deficiency in the systems and operations of the Sponsor(s) and/ or the AMC and/ or the Board of Trustees/Trustee Company which SEBI has specifically advised to be disclosed in the SID, or which has been notified by any other regulatory agency, shall be disclosed.

Notwithstanding anything contained in this Scheme Information Document, the provisions of the SEBI (Mutual Funds) Regulations, 1996 and the guidelines there under shall be applicable.

4.4 Appendix 4: Key Information Memorandum

Name of AMC & MF

(Type of scheme)

KEY INFORMATION MEMORANDUM

--------- Scheme

(_)

Offer for Units of Rs. -- Per Unit for cash during the
New fund Offer Period and at NAV based prices upon re-opening

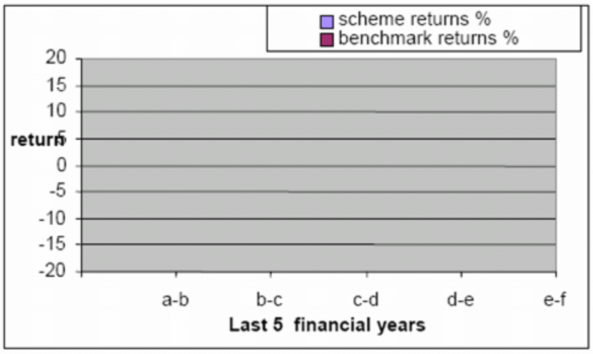
New Fund Offer Opens on: **New Fund Offer Closes on:** **Scheme Re-opens for continuous sale and repurchase on:**

This Key Information Memorandum (KIM) sets forth the information, which a prospective investor ought to know before investing. **For further details of the scheme/Mutual Fund, due diligence certificate by the AMC, Key Personnel, investors' rights & services, risk factors, penalties & pending litigations etc. investors should, before investment, refer to the Scheme Information Document and Statement of Additional Information available free of cost at any of the Investor Service Centres or distributors or from the website www. -----.**

The Scheme particulars have been prepared in accordance with Securities and Exchange Board of India (Mutual Funds) Regulations 1996, as amended till date, and filed with Securities and Exchange Board of India (SEBI). The units being offered for public subscription have not been approved or disapproved by SEBI, nor has SEBI certified the accuracy or adequacy of this KIM.

Investment Objective			
Asset Allocation Pattern of the scheme	Types of Instruments	Normal Allocation (% of Net Assets)	
Risk Profile of the Scheme	Mutual Fund Units involve investment risks including the possible loss of principal. Please read the SID carefully for details on risk factors before investment. Scheme specific Risk Factors are summarized below:		

<table>
<tr><td>Plans and Options</td><td></td><td colspan="2"></td></tr>
<tr><td>Applicable NAV (after the
scheme opens for repurchase and sale)</td><td></td><td colspan="2"></td></tr>
<tr><td>Minimum Application Amount/ Number of Units</td><td>Purchase</td><td>Additional Purchase</td><td>Repurchase</td></tr>
<tr><td>Despatch of Repurchase (Redemption) Request</td><td colspan="3">Within 10 working days of the receipt of the redemption request at the authorised centre of the ------- Fund.</td></tr>
<tr><td>Benchmark Index</td><td colspan="3"></td></tr>
<tr><td>Dividend Policy</td><td colspan="3"></td></tr>
<tr><td>Name of the Fund Manager</td><td colspan="3"></td></tr>
<tr><td>Name of the Trustee Company</td><td colspan="3"></td></tr>
<tr><td rowspan="6">Performance of the scheme :

[In case of a new scheme, the statement should be given “This scheme does not have any performance track record”]
Or
[In case of a scheme in existence, the return figures shall be given for that scheme only, as per the For a scheme which is in existence for more than 1 year, the returns given will be Compounded Annualised Returns and for scheme which is in existence for less than 1 year, the</td><td>Compounded Annualised Returns</td><td>Scheme Returns %</td><td>Benchmark Returns %</td></tr>
<tr><td>Returns for the last 1
year</td><td></td><td></td></tr>
<tr><td>Returns for the last 3
years</td><td></td><td></td></tr>
<tr><td>Returns for the last 5
years</td><td></td><td></td></tr>
<tr><td>Returns since inception</td><td></td><td></td></tr>
<tr><td colspan="3">Absolute Returns for each financial year for the last 5 years

</td></tr>
</table>

<table>
<tr><td>returns would be absolute returns since inception.
Absolute returns for each
financial year for the last 5 years shall be represented by means of a bar diagram as per the adjacent format.]</td><td colspan="2"></td></tr>
<tr><td rowspan="3">Expenses of the Scheme

(i) Load Structure

(ii) Recurring expenses</td><td>New Fund Offer Period</td><td>Continuous Offer</td></tr>
<tr><td>Entry load :
Exit load :
CDSC (if any):</td><td>Entry load :
Exit load :
CDSC (if any):</td></tr>
<tr><td>First Rs. 100 crores of the average weekly net assets :
Next Rs. 300 crores of the average weekly net assets :
Next Rs. 300 crores of the average weekly net assets :
Balance :</td><td>Actual expenses for the previous financial year: ----
(Not Applicable in case of a new scheme)</td></tr>
<tr><td>Waiver of Load for Direct Applications</td><td colspan="2">The applicable procedure should be given in brief.</td></tr>
<tr><td>Tax treatment for the Investors (Unitholders)</td><td colspan="2">Investor will be advised to refer to the details in the Statement of Additional Information and also independently refer to his tax advisor.</td></tr>
<tr><td></td><td colspan="2"></td></tr>
</table>

Daily Net Asset Value (NAV) Publication	The NAV will be declared on all ------- days and will be published in 2 newspapers. NAV can also be viewed on www.___ and www.amfiindia.com [You can also telephone us at ------ (optional)].	
For Investor Grievances please contact	Name and Address of Registrar	Name, address, telephone number, fax number, e-mail id ------
Unitholders' Information	Give the frequency and the policy of the fund house for the providing the Accounts Statement, Annual Financial results and Half yearly portfolio to the investors.	

Date:
N.B. Data and information shall be up-to-date but in no case older than 30 days from the date of KIM

Additional Disclosures for close ended debt oriented schemes:

In order to enable investors to make a more informed decision with regards to the quality of securities and risk associated with different close ended debt oriented schemes, Mutual Funds/ AMCs shall make following additional disclosures in the SID/SAI and KIM without indicating the portfolio or yield, directly or indirectly:

a. Credit evaluation policy for the investments in debt securities.
b. List of sectors the AMC would not be investing for the particular scheme.
c. The type of instruments which the schemes propose to invest viz. CPs, CDs, Treasury bills etc.
d. The floors and ceilings within a range of 5%of the intended allocation (in %) against each sub asset class/credit rating.

After the closure of NFO, the AMCs will report in the next meeting of AMCs and Trustees the publicized percentage allocation and the final portfolio. Variations between indicative portfolio allocation and final portfolio will not be permissible.

Further, mutual funds must ensure that total exposure of debt schemes of mutual funds in a particular sector (excluding investments in Bank CDs, CBLO, G-Secs, T-Bills and AAA rated securities issued by Public Financial Institutions and Public Sector Banks) do not exceed 30% of the net assets of the scheme.

Sample Questions

1. NFOs other than ELSS can be open for a maximum of _____.

a. 7 days
b. 10 days
c. 15 days
d. 30 days

2. Legally, SAI is part of the SID.

a. True
b. False

3. Offer documents of mutual fund schemes are approved by SEBI.

a. True
b. False

4. Application form is attached to ______.

a. SID
b. SAI
c. KIM
d. None of the above

5. KIM has to be updated every 6 months.

a. True
b. False

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CHAPTER 5: FUND DISTRIBUTION AND CHANNEL MANAGEMENT PRACTICES

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Distribution Channels – Traditional and New
- Commission Structure in mutual fund

5.1 Distribution Channels

5.1.1 Traditional Distribution Channels

Individual

Historically, individual agents would distribute units of Unit Trust of India and insurance policies of Life Insurance Corporation. They would also facilitate investments in Government's Small Savings Schemes. Further, they would sell Fixed Deposits and Public Issues of shares of companies, either directly, or as a sub-broker of some large broker.

UTI, LIC or other issuer of the investment product (often referred to in the market as "product manufacturers") would advertise through the mass media, while an all-India field force of agents would approach investors to get application forms signed and collect their cheques. The agents knew the investors' families personally – the agent would often be viewed as an extension of the family.

Over the last two decades or so, a number of changes happened:

- Several new insurance and mutual fund companies commenced operations.
- The universe of investment products available for investors multiplied.
- Investors are better informed about many products and their features.
- Technologies like the internet and data mining software opened the doors to newer ways of targeting investors, sharing information with them, and putting through their transactions.
- Companies started offering products in more and more locations, thus increasing the pressure on the product manufacture-to-agent, single level distribution architecture.
- A need was felt for newer formats of distribution that would leverage on the above to generate much higher volumes in the market.

Individual distributors, also referred to as Individual Financial Advisors (IFA) continue to be a large force for distribution numerically, though the volume of sales generated are significantly lower than other distribution channels such as Institutional Distributors.

Institutional Channels

The changing competitive context led to the emergence of institutional channels of distribution for a wide spectrum of financial products. This comprised:

- Brokerage firms and other securities distribution companies, who widened their offering beyond company Fixed Deposits and public issue of shares.
- Banks, who started viewing distribution of financial products as a key avenue to earn fee-based income, while addressing the investment needs of their customers.
- Non-banking finance companies (NBFC) with multiple branches.

Some operated within states; many went national. A chain of offices manned by professional employees or affiliated sub-brokers became the face of mutual fund distribution. Brand building, standardized processes and technology sharing became drivers of business for these institutions – unlike the personal network, which generated volumes for the individual agents. Investors also benefit from the investment research and other services that these institutions provide to their clients.

Limitations of employee bandwidth and staff strength meant that product manufacturers preferred to deal with a few institutions. The benefit was that they could reach out to hundreds of locations, while having to negotiate deals with only a select few in the head office of the distributing institution. AMCs appointed Channel Managers on their rolls, whose job it was, to get the best out of these institutional distribution channels.

The institutional channels started attracting agents as sub-brokers. Many individual agents opted to associate with the institutional channels, so that they could give their customers the benefit of newer technologies and services (which the agents found too costly to offer on their own).

Thus, the distribution setup has got re-aligned towards a mix of:

- Independent Financial Advisors (IFAs), who are individuals. The bigger IFAs operate with support staff who handles back-office work, while they themselves focus on sales and client relationships. They also had sub-brokers working under them.
- Non-bank distributors, such as brokerages, securities distribution companies and non-banking finance companies
- Bank distributors

Ownership of all-India or regional network of locations meant that the institutional channels could deal with product manufacturers as equals, and negotiate better terms than what the agents could manage.

Down the line, the AMCs also started exploring other channels of distribution. Post offices and self-help groups are examples of such alternate channels. Alternate Channel Managers on the rolls of the company are responsible for such exploratory thrusts.

5.1.2 Newer Distribution Channels

Internet

The internet gave an opportunity to mutual funds to establish direct contact with investors. Investors could access the website of the mutual fund and deal directly with the fund. Direct transactions afforded scope to optimize on the commission costs involved in distribution.

Investors, on their part, have found a lot of convenience in doing transactions instantaneously through the internet, rather than get bogged down with paper work and having to depend on a distributor to do transactions. This has put a question mark on the existence of intermediaries who focus on pushing paper, but add no other value to investors.

A few professional distributors have rightly taken the path of value added advice and excellent service level to hold on to their customers and develop new customer relationships. Many of them offer transaction support through their own websites.

A large mass of investors in the market need advice. The future of intermediaries lies in catering to their needs, personally and / or through a team and / or with support of technology.

Stock Exchanges

The institutional channels have had their limitations in reaching out deep into the hinterland of the country. A disproportionate share of mutual fund collections has tended to come from corporate and institutional investors and from urban centers, rather than retail individuals for whose benefit the mutual fund industry exists.

Stock exchanges, on the other hand, have managed to ride on the equity cult in the country and the power of communication networks to establish a cost-effective all-India network of brokers and trading terminals. This has been a successful initiative in the high-volume low-margin model of doing business, which is more appropriate and beneficial for the country.

SEBI has facilitated buying and selling of mutual fund units through the stock exchanges. Both NSE and BSE have developed mutual fund transaction engines for the purpose. These are discussed in Chapter7. The underlying premise is that the low cost and deeper reach of the stock exchange network can increase the role of retail investors in mutual funds, and take the mutual fund industry into its next wave of growth.

While the transaction engines are a new phenomenon, stock exchanges always had a role in the following aspects of mutual funds, which were discussed in Chapter1:

- Close-ended schemes are required to be listed in a stock exchange
- ETFs are bought and sold in the stock exchange.

Distribution through PSU Banks

Mutual funds have been encouraged to build relationships with PSU banks that have a wide reach in the non-urban centres to distribute mutual fund products through them.

SEBI has also permitted mutual funds to charge an additional expense ratio of 30 bps for garnering funds from B15 cities.

5.1.3 New Cadre of Distributors

SEBI, in September 2012, provided for a new cadre of distributors, such as postal agents, retired government and semi-government officials (class III and above or equivalent), retired teachers and retired bank officers with a service of at least 10 years, and other similar persons (such as Bank correspondents) as may be notified by AMFI/ AMC from time to time. These new distributors are allowed to sell units of simple and performing mutual fund schemes.

Simple and performing mutual fund schemes comprise of diversified equity schemes, fixed maturity plans (FMPs) and index schemes that have returns equal to or better than their scheme benchmark returns during each of the last three years.

These new cadre of distributors require a simplified form of NISM certification and AMFI Registration. These requirements are discussed in the sections that follow.

5.1.4 Pre-requisites to become Distributor of a Mutual Fund

A fund may appoint an individual, bank, non-banking finance company or distribution company as a distributor. No SEBI permission is required before such appointment.

SEBI has prescribed a Certifying Examination, passing in which is compulsory for anyone who is in the business of selling mutual funds, whether as IFA, or as employee of a distributor or AMC. Qualifying in the examination is also compulsory for anyone who interacts with mutual fund investors, including investor relations teams and employees of call centres.

In order to be eligible to sell or market mutual funds, the following are compulsory:

- The individual needs to pass the Certifying Examination prescribed by SEBI. Distributors / employees who were above the age of 50 years, and had at least 5 years of experience as on September 30, 2003 were exempted. But they need to attend a prescribed refresher course.

- KYD Requirements

As part of SEBI's drive to streamline the distribution process of mutual fund products, AMFI has introduced the KYD process to verify the correctness of the information provided in the registration documents and to have verification of the ARN holders.

The process consists of document verification and bio-metric process

- Self-attested copy of the PAN card and specific documents as proof of address to be submitted along with application form at the CAMS- PoS. The original documents have to be presented for verification.
- Bio-metric process consists of taking the impression of the index finger of the right hand of the ARN holder. This will be done at the PoS at the time submission of documents
- In case of non-individual distributors, bio-metric process will be conducted on specified authorized persons
- An acknowledgement confirming the completion of KYD process is received from the CAMS-PoS
- A photocopy of the acknowledgement has to be sent to all the AMCs with whom the distributor is empanelled

The new rules are applicable to new registrations and renewals have come to effect from September 1, 2010.

- After passing the examination and completing KYD requirements, the next stage is to register with AMFI. On registration, AMFI allots an AMFI Registration Number (ARN). Individuals from the exempted category described above can obtain the ARN without passing the Certifying Examination, provided they have attended the prescribed refresher course.
- Armed with the ARN No., the IFA / distributor / stock exchange broker can get empanelled with any number of AMCs. Alternatively, they can become agents of a distributor who is already empanelled with AMCs. Empanelment with the AMC, or enrolment as an agent of an empanelled distributor is compulsory to be able to sell mutual fund schemes and earn the commissions.

Institutions that are into distribution of mutual funds need to register with AMFI. Besides, all their employees who are into selling mutual funds need to have an ARN. The employees need to obtain an Employee Unique Identification Number (EUIN) from AMFI apart from AMFI Registration Number (ARN). The Intermediaries have to ensure that the employees quote the EUIN in the Application Form for investments.

The new cadre of distributors mentioned in 5.1.3 above are not required to comply with KYD/ bio-metrics requirements. However, they are required to submit self-attested copies of identity proof (photo PAN card of individual applicants/ in case of Proprietary concern, PAN card of the Proprietary Concern (if available) or Photo PAN Card of the Proprietor) and address proof, as mentioned in KYD application form.

Series V-B: Mutual Fund Foundation Certification Examination and Mutual Fund Foundation CPE Program have been specially designed by NISM for this new cadre of distributors.

5.1.5 Conditions for Empanelment

Empanelment with an AMC is a simple process. There is a standard Request for Empanelment Form to be filled. This provides for basic details, such as

- Personal Information of applicant – Name of person, age, Trade Name, Contact Information, ARN, PAN, Income tax category (such as Resident Individual, Company, Non-Resident Indian, Foreign Company)
- Names and contact information of key people handling sales and operations
- Business details, such as office area, number of branches, number of employees, geographical area covered, years of experience, number of investors, number of agents / sub-brokers, fund houses already empanelled in, size of AUM etc.
- Bank details and preferences regarding Direct Credit of brokerage in the bank account
- Preferences regarding receiving information from the AMC
- Nominee
- The applicant also needs to sign a declaration, which provides for the following:
    - Correctness and completeness of information provided
    - Commitment to keep all the transactional information confidential
    - Commitment to abide by instructions given, as also statutory codes, guidelines and circulars
    - Not to issue advertisement or publicity material other than that provided by the AMC or pre-approved by the AMC
    - Ensure that the risk factors are mentioned along with performance and other related information
    - Provide all the information and documents that the AMC may ask for from time to time

- Ensure that all employees who are engaged in selling or marketing of mutual funds have an ARN.
- Undertake not to rebate commission back to investors, or attract investors through temptation of rebate / gifts, pass back of commission etc.
- Power to the AMC to terminate the empanelment at any time
- Some AMCs directly empanel only distributors who are likely to generate adequate business – and request others to work under one or the other empanelled distributors.
- At times, AMCs link the levels of commission to the volumes generated. In such cases, an agent might find it beneficial to work under an established distributor.

5.2 Channel Management Practices

5.2.1 Commission Structures

There are no SEBI regulations regarding the minimum or maximum commission that distributors can earn. However, SEBI has laid down limits on what the total expense (including commission) in a scheme can be. This is discussed in Chapter 6. Any excess will need to be borne by the AMC i.e. it cannot be charged to the scheme.

The commission structures vary between AMCs. Even for the same AMC, different commissions are applicable for different kinds of schemes. Two kinds of commission are earned by distributors on their mobilization:

Initial or Upfront Commission, on the amount mobilized by the distributor.

The scheme application forms carry a suitable disclosure to the effect that the upfront commission to distributors will be paid by the investor directly to the distributor, based on his assessment of various factors including the service rendered by the distributor. Some distributors have worked out standardized contracts with their clients, where either a fixed amount per period or a percentage of the transaction value is recovered as fees. As part of the contract, some banks debit the commission to the investor's savings bank account held with the bank.
Investors should make sure that the commission costs they incur are in line with the value they get.

Trail commission, calculated as a percentage of the net assets attributable to the Units sold by the distributor.

The trail commission is normally paid by the AMC on a quarterly basis. Since it is calculated on net assets, distributors benefit from increase in net assets arising out of valuation gains in the market.

For example, suppose an investor has bought 1000 units at Rs 10 each. The distributor who procured the investment may have been paid an initial commission calculated as a percentage on 1000 units X Rs 10 i.e. Rs 10,000.

Later, suppose the NAV of the scheme goes up to Rs15. Trail commission is payable on 1000 units X Rs 15 i.e. Rs 15,000 – not the Rs 10,000 mobilised.

Further, unlike products like insurance, where agent commission is paid for a limited number of years, a mutual fund distributor is paid a commission for as long as the investor's money is held in the fund.

Such indexing of agent commissions to the current value of the investment, and the absence of a time limitation to earning it, are unique benefits that make it attractive for distributors to sell mutual funds.

Smart distributors have accumulated a portfolio of loyal investors to whom they offer superior service. The trail commission on these investments ensures a steadily rising income for the distributor. Additional investments from the same investors, and other investors referred by the current investors, help them grow the portfolio.

A point to note is that the commission is payable to the distributors to mobilise money from their clients. Hence, no commission – neither upfront nor trail – is payable to the distributor for their own investments (self-business).

Regulations require distributors to disclose to their investor all commissions in the form of trail commissions or any other form payable to them from similar competing schemes of different mutual fund from amongst which the particular scheme was recommended to the investor.

Transaction Charges

A transaction charge is paid to distributors for investments of Rs. 10,000 and over. This does not apply to direct investments. For subscriptions from existing investors the distributor will be paid Rs. 100 per transaction and for new investors they will be paid Rs. 150 to encourage widening the investor base of mutual funds.

The transaction charge will be deducted from the gross investments of the investor and paid to the investor and the balance shall be invested. The statement of accounts (SoA) will show the net investment made as the gross subscription less transaction charge and give the number of units allotted against the net subscription.

In case of SIPs, transaction charges are applicable only if the total commitments through SIPs amounts to Rs. 10,000 and above. The transaction charge will be recovered in 3-4 instalments.

Distributors have the option of opting out of charging transaction charges. But such opting out shall be applicable only at distributor level. This means that the distributor cannot choose to charge transaction charge from one investor and not from another. Distributors will also have the option to opt in or opt out of levying the transaction charge based on the type of product.

Commission Disclosure

SEBI has mandated Mutual Funds / AMCs to disclose on their respective websites the total commission and expenses paid to distributors who satisfy one or more of the following conditions with respect to non-institutional (retail and HNI) investors:

i. Multiple point of presence (More than 20 locations)

ii. AUM raised over Rs. 100 crore across industry in the non-institutional category but including high networth individuals (HNIs).

iii. Commission received of over Rs. 1 crore p.a. across industry

iv. Commission received of over Rs. 50 lakhs from a single Mutual Fund/AMC.

Mutual Funds / AMCs shall also submit the above data to AMFI. AMFI shall disclose the consolidated data in this regard on its website.

In addition to the total commission and expenses paid to distributors, mutual funds / AMCs need to make additional disclosures regarding distributor-wise gross inflows (indicating whether the distributor is an associate or group company of the sponsor(s) of the mutual fund), net inflows, average assets under management and ratio of AUM to gross inflows on their respective website on an yearly basis.

In case the data indicates that a distributor has an excessive portfolio turnover ratio, i.e. more than two times the industry average, AMCs conduct additional due-diligence of such distributors.

Mutual Funds/ AMCs are required to submit the above data to AMFI and a consolidated data with respect to the same will be disclosed on AMFI website.

5.2.2 Multi-level Distribution Channel

As seen earlier, large distributors have agents / sub-brokers working under them. Being the principal, the distributor is bound by the acts of agents / sub-brokers. The distributor therefore needs to ensure that the agents comply with all the regulations. A point to note is that while distribution companies may have sub-brokers, banks generally do not appoint sub-brokers.

Typically, AMCs structure their relationship with distributors as Principal to Principal. Therefore, the AMC it is not bound by the acts of the distributor, or the distributor's agents or sub-brokers.

5.2.3 ACE and AMFI's Code of Conduct for Intermediaries of Mutual Funds

Every person who is into selling of mutual funds should be familiar with the AMFI Code of Ethics (ACE) and AMFI's Code of Conduct for Intermediaries of Mutual Funds. These were discussed in Chapter3.

5.2.4 SEBI Regulations related to Sales Practices

Distributors can claim commission on investments made through them by their clients. However, no commission is payable on their own investments.

The distributors have to disclose all the commissions (in the form of trail commission or any other mode) payable to them for the different competing schemes of various mutual funds from amongst which the scheme is being recommended to the investor.

The practice of rebating i.e., sharing part of the commission earned with the investors, is banned. This was discussed in the section on AMFI's Code of Conduct for Intermediaries of Mutual Funds in Chapter3.

5.2.5 SEBI Advertising Code

The important provisions are listed below. The requirements regarding returns will be better appreciated, after reading Chapter 8.

- Advertisements shall be accurate, true, fair, clear, complete, unambiguous and concise.
- Advertisements shall not contain statements which are false, misleading, biased or deceptive, based on assumption/projections and shall not contain any testimonials or any ranking based on any criteria.
- Advertisements shall not be so designed as likely to be misunderstood or likely to disguise the significance of any statement. Advertisements shall not contain statements which directly or by implication or by omission may mislead the investor.
- Advertisements shall not carry any slogan that is exaggerated or unwarranted or slogan that is inconsistent with or unrelated to the nature and risk and return profile of the product.
- No celebrities shall form part of the advertisement.
- Advertisements shall not be so framed as to exploit the lack of experience or knowledge of the investors. Extensive use of technical or legal terminology or complex language and the inclusion of excessive details which may detract the investors should be avoided.
- Advertisements shall contain information which is timely and consistent with the disclosures made in the Scheme Information Document, Statement of Additional Information and the Key Information Memorandum.

- No advertisement shall directly or indirectly discredit other advertisements or make unfair comparisons.
- Advertisements shall be accompanied by a standard warning in legible fonts which states 'Mutual Fund investments are subject to market risks, read all scheme related documents carefully.' No addition or deletion of words shall be made to the standard warning.
- In audio-visual media based advertisements, the standard warning in visual and accompanying voice over reiteration shall be audible in a clear and understandable manner. For example, in standard warning both the visual and the voice over reiteration containing 14 words running for at least 5 seconds may be considered as clear and understandable.
- The dividends declared or paid shall also be mentioned in Rupees per unit along with the face value of each unit of that scheme and the prevailing NAV at the time of declaration of the dividend.
- While advertising returns by assuming reinvestment of dividends, if distribution taxes are excluded while calculating the returns, this fact shall also be disclosed
- While advertising pay out of dividends, all advertisements shall disclose, immediately below the dividend figure (in percentage or in absolute terms) and in the same font size that the NAV of the scheme, pursuant to payment of dividend would fall to the extent of payout and statutory levy (if applicable)
- When the mutual fund scheme has been in existence for more than three years:
    - Point-to-point returns on a standard investment of Rs. 10,000/- shall also be shown in addition to CAGR for a scheme in order to provide ease of understanding to retail investors.
    - Performance advertisement shall be provided since inception and for as many twelve month periods as possible for the last 3 years, such periods being counted from the last day of the calendar quarter preceding the date of advertisement, along with benchmark index performance for the same periods.
- Where scheme has been in existence for more than one year but less than three years, performance advertisement of scheme(s) shall be provided for as many as twelve month periods as possible, such periods being counted from the last day of the calendar quarter preceding the date of advertisement, along with benchmark index performance for the same periods.
- Where the scheme has been in existence for less than one year, past performance shall not be provided.

- In the case of money market schemes or cash and liquid schemes, wherein investors have very short investment horizon, the performance can be advertised by simple annualisation of yields if a performance figure is available for at least 7 days, 15 days and 30 days. Further, it should not give an unrealistic or misleading picture about the performance or future performance of the scheme.

- For the sake of standardization, a similar return in INR and by way of CAGR must be shown for the following apart from the scheme benchmarks:

Scheme Type	**Benchmark**
Equity scheme	Sensex or Nifty
Long term debt scheme	10 year dated GoI security
Short-term debt fund	1 year T-Bill

- These disclosures shall form a part of the Statement of Additional Information and all advertisements of Mutual Funds. Any disclosure regarding quarterly/half yearly/yearly performance shall pertain to respective calendar quarterly/half yearly/yearly only.

- When the performance of a particular Mutual Fund scheme is advertised, the advertisement shall also include the performance data of all the other schemes managed by the fund manager of that particular scheme.

- In case the number of schemes managed by a fund manager is more than six, then the AMC may disclose the total number of schemes managed by that fund manager along with the performance data of top 3 and bottom 3 schemes (in addition to the performance data of the scheme for which the advertisement is being made) managed by that fund manager in all performance related advertisement. However, in such cases AMCs shall ensure that true and fair view of the performance of the fund manager is communicated by providing additional disclosures, if required.

Sample *Questions*

1. Institutional distributors build reach through ______.

a. Employees
b. Agents
c. Sub-brokers
d. **Any of the above**

2. The maximum initial commission that a scheme can pay to distributors is ____.

a. **Nil**
b. 0.05%
c. 1%
d. 2%

3. The distributor can charge a fee from the investor.

a. **True**
b. False

4. Stock exchange brokers are permitted to distribute mutual funds without the requirement of passing the certifying test.

a. True
b. **False**

5. Trail commissions are linked to valuation of portfolio in the market.

a. **True**
b. False

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CHAPTER 6: ACCOUNTING, VALUATION AND TAXATION

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Accounting of mutual fund schemes
- Calculation of net asset value
- Valuation of securities in the scheme's portfolio
- Impact of taxation on various types of mutual fund schemes and investors in these schemes practices

6.1 Accounting and Expenses

6.1.1 Net Assets of Scheme

Let us understand the concept with a simple example.

Investors have bought 20 crore units of a mutual fund scheme at Rs10each. The scheme has thus mobilized 20 crore units X Rs 10 per unit i.e. Rs 200 crore.

An amount of Rs 140 crore, invested in equities, has appreciated by 10%.

The balance amount of Rs 60 crore, mobilized from investors, was placed in bank deposits.

Interest and dividend received by the scheme is Rs8crore, scheme expenses paid is Rs 4 crore, while a further expense of Rs1crore is payable.

If the above details are to be captured in a listing of assets and liabilities of the scheme, it would read as follows:

	Amount (Rs cr.)
Liabilities	
Unit Capital (20 crore units of Rs10 each)	200
Profits {Rs 8 crore (interest and dividend received) minus Rs 4 crore (expenses paid) minus Rs 1 crore (expenses payable)}	3
Capital Appreciation on Investments held (10% of Rs 140 crore)	14
Unit-holders' Funds in the Scheme	**217**
Expenses payable	1
Scheme Liabilities	**218**

Assets	
Market value of Investments (Rs 140 crore + 10%)	154
Bank Deposits {Rs 60 crore (original) plus Rs 8 crore (interest and dividend received) minus Rs 4 crore (expenses paid)}	64
Scheme Assets	**218**

The unit-holders' funds in the scheme is commonly referred to as "net assets". The assets of the scheme are the investments held by it. This along with the accrued income which include dividend or interest due on securities held in the portfolio but not yet received, and receivables, such as amount due on shares sold, constitute the total assets. The scheme may have some short-term liabilities and accrued expenses. The current liabilities include payables for securities bought and borrowings for periods not exceeding six months to meet liquidity needs.

As is evident from the table:

- Net assets includes the amounts originally invested, the profits booked in the scheme, as well as appreciation in the investment portfolio.
- Net assets go up when the market prices of securities held in the portfolio go up, even if the investments have not been sold and profits realized.
- A scheme cannot show better profits by delaying payments. While calculating profits, all the expenses that relate to a period need to be considered, irrespective of whether or not the expense has been paid. In accounting jargon, this is called accrual principle.
- Similarly, any income that relates to the period will boost profits, irrespective of whether or not it has been actually received in the bank account. This again is in line with the accrual principle.

6.1.2 Net Asset Value (NAV)

In the market, when people talk of NAV, they refer to the value of each unit of the scheme. This is equivalent to:

Unit-holders' Funds in the Scheme (Net Assets) ÷ No. of Units

In the above example, it can be calculated as:

Rs 217 crore ÷ 20 crore

i.e. Rs 10.85 per unit.

An alternate formula for calculating NAV is:

(Total Assets minus Liabilities other than to Unit holders) ÷ No. of Units i.e. (Rs 218 crore – Rs 1 crore) ÷ 20 crore

i.e. Rs 10.85 per unit.

From the above, it follows that:

- Higher the interest, dividend and capital gains earned by the scheme, higher would be the NAV.
- Higher the appreciation in the investment portfolio, higher would be the NAV.
- Lower the expenses, higher would be the NAV.

The summation of these three parameters gave us the *profitability metric,* which was introduced in Chapter 1 as being equal to:

(A) Interest income
(B) + Dividend income
(C) + Realized capital gains
(D) + Valuation gains
(E) – Realized capital losses
(F) – Valuation losses
(G) – Scheme expenses

Calculate the NAV given the following information:

- Value of stocks: Rs. 150 cr,
- Value of bonds: Rs. 67 cr
- Value of money market instruments: Rs. 2.36 cr,
- Dividend accrued but not received: Rs. 1.09 cr,
- Interest accrued but not received: Rs. 2.68 cr
- Fees payable: Rs. 0.36 cr,
- No. of outstanding units: 1.90 cr

NAV = (Value of stocks + Value of bonds + Value of money market instruments + Dividend accrued but not received + Interest accrued but not received – Fees payable) / No. of outstanding units

NAV = (150 + 67 + 2.36 + 1.09 + 2.68 – 0.36) / 1.90 = 222.77 / 1.90 = Rs. 117.25

Calculate the NAV given the following information:

- Value of stocks: Rs. 230 cr,
- Value of money market instruments: Rs. 5 cr,
- Dividend accrued but not received: Rs. 2.39 cr,
- Amount payable on purchase of shares: Rs. 7.5 cr

- Amount receivable on sale of shares: Rs. 2.34 cr
- Fees payable: Rs. 0.41 cr,
- No. of outstanding units: 2.65 cr

NAV = (Current value of investments held + Income accrued + Current assets – Current liabilities – Accrued expenses / No. of outstanding units

Income accrued is the dividend declared but not received. Expenses accrued include fees payable. The NAV is calculated as

NAV = (230 + 5 + 2.39 + 2.34 – 7.5 – 0.41) / 2.65 = 231.82 / 2.65 = Rs. 87.48

6.1.3 Mark to Market

The process of valuing each security in the investment portfolio of the scheme at its current market value is called '*mark to market*' i.e. marking the securities to their market value. Why is this done?

The NAV is meant to reflect to true worth of each unit of the scheme, because investors buy or sell units on the basis of the information contained in the NAV. If investments are not marked to market, then the investment portfolio will end up being valued at the cost at which each security was bought. Valuing shares of a company at their acquisition cost, say Rs15, is meaningless, if those shares have appreciated to, sayRs50. If the scheme were to sell the shares at the time, it would recover Rs50 – not Rs15. When the NAV captures the movement of the share from Rs15 to Rs50, then it is meaningful for the investors.

What happens if the portfolio was not marked to market and investors are issued units post the NFO also at the face value of the unit? Consider the following example.

Unit capital:	Rs. 100,000
Face value/unit:	Rs. 10
No. of units issued:	10000 (Rs. 100,00 / Rs. 10)
Net Assets:	Rs. 150,000
NAV:	Rs. 15

Assume an investor buys 100 units when the NAV is Rs. 15 and the units are issued to him at the face value of Rs. 10. Post the purchase the scheme's numbers will be as follows

Unit capital:	Rs. 101,000
Face value/unit:	Rs. 10
No. of units:	10100 (Rs. 101,00 / Rs. 10)
Net Assets:	Rs. 151,000

NAV: Rs. 14.95

Assume an investor redeems 100

Assume an investor redeems 100 units when the NAV is Rs. 15 and the units are redeemed at the face value of Rs. 10. Post the redemption the schemes numbers will look as follows

Unit capital:	Rs. 99,000
Face value/unit:	Rs.10
No. of units:	9900 (Rs. 100,00 / Rs. 10)
Net Assets:	Rs. 150,000
NAV:	Rs. 15.15

Issuing fresh units at a price lower than the NAV will result in the post issue NAV coming down for all investors. Redeeming units at price lower than the NAV will increase the NAV for the remaining investors.

Thus, marking to market helps investors buy and sell units of a scheme at fair prices, which are determined based on transparently calculated and freely shared information on NAV. As will be seen in Chapter 8, such mark-to-market based NAV also helps in assessing the performance of the scheme / fund manager.

6.1.4 Sale Price, Re-purchase Price and Loads

A distinctive feature of open-ended schemes is the ongoing facility to acquire new units from the scheme ("sale" transaction) or sell units back to the scheme ("re-purchase transaction").

In the past, schemes were permitted to keep the Sale Price higher than the NAV. The difference between the Sale Price and NAV was called the "entry load". If the NAV of a scheme was Rs11.00 per unit, and it were to charge entry load of 1%, the Sale Price would be Rs11 + 1% on Rs11 i.e. Rs11.11. Entry load is no longer permitted. So Sale Price is the same as NAV.

Schemes are permitted to keep the Re-purchase Price lower than the NAV. The difference between the NAV and Re-purchase Price is called the "exit load". If the NAV of a scheme is Rs11.00 per unit, and it were to charge exit load of 1%, the Re-purchase Price would be Rs11 – 1% on Rs11 i.e. Rs10.89.

Schemes can also calibrate the load when investors offer their units for re-purchase. Investors would be incentivized to hold their units longer, by reducing the load as the unit holding period increased. For instance, load would be 4% if the investor were to exit in year 1, 3% if the investor were to exit in year 2, and so on. Such structures of load are called "Contingent Deferred Sales Charge (CDSC)".

Earlier, schemes had the flexibility to differentiate between different classes of investors within the same scheme, by charging them different levels of load. Further, all the moneys collected as loads were available for the AMC to bear various selling expenses. There were liberal limits on how much could be charged as loads.

However, the current position is that:

- SEBI has banned entry loads. So, the Sale Price needs to be the same as NAV (subject to deduction of applicable transaction charges, if any, as discussed in the next section).
- While charging exit loads, no distinction will be made among unitholders on the basis of the amount of subscription. While complying with the same, any imposition or enhancement in the load shall be applicable only on prospective investments. The parity among unitholders on exit load shall be made applicable at portfolio level.
- No exit load will be charged on bonus units and units allotted on reinvestment of dividend.
- Exit loads / CDSC have to be credited back to the scheme immediately i.e. they are not available for the AMC to bear selling expenses.
- Upfront commission to distributors will be paid by the investor directly to the distributor, based on his assessment of various factors including the service rendered by the distributor.

Now that schemes cannot have an entry load, the sale price would be equal to the scheme NAV. Say for example, if an investor invests Rs. 25,000 in a scheme with NAV of Rs. 43.21, she will get 578.570 units.

- Amount invested: Rs. 25,000
- NAV: Rs. 43.21
- Units allotted: Rs. 25,000 / Rs. 43.21 = 578.570 units

6.1.5 Transaction Charges

In order to cater to people with small saving potential and to increase reach of mutual fund products in urban areas and smaller towns, SEBI has allowed a transaction charge per subscription of Rs. 10,000/- and above to be paid to distributors of the Mutual Fund products. However, there shall be no transaction charges on direct investments. The transaction charge, if any, is deducted by the AMC from the subscription amount and paid to the distributor; and the balance shall be invested.

Type of Investor	**Transaction Charges (Rs.)** **(for purchase/subscription of Rs. 10,000 and above)**

First time mutual fund investor	Rs. 150/-
Investor other than first time mutual fund investor	Rs. 100/-

In the previous example of Rs. 25,000 investment at NAV of Rs. 43.21, suppose money came from a first-time mutual fund investor. Transaction charge would be deductible at Rs. 150. So the number of units allotted would be (Rs. 25,000 – Rs. 150) ÷ Rs. 43.21 i.e. 575.098.

In case of investments through SIP, Transaction Charge(s) are deducted only if the total commitment (i.e. amount per SIP instalment x Number of instalments) amounts to Rs. 10,000 or more. The Transaction Charge(s) is deducted in four equal instalments.

However, Transaction Charge(s) will not be deducted for the following:-

- Purchase/Subscription submitted by investor at the designated collection centres or through AMC's website and which are not routed through any distributor.
- Purchase/ Subscription through a distributor for an amount less than Rs. 10,000;
- Transactions such as Switches, STP i.e. all such transactions wherein there is no additional cash flow at a mutual fund level similar to Purchase/Subscription.
- Purchase/Subscriptions through any stock exchange.

Opt – out Option

Distributors can choose to opt out of charging the transaction charge based on type of the product e.g. they can decide not to charge it for debt schemes. However, the 'opt-out' shall be at distributor level and not investor level i.e. a distributor cannot charge one investor, and choose not to charge another investor.

6.1.6 Expenses

Two kinds of expenses come up in creating and managing a mutual fund:

Initial Issue expenses are incurred at the time of launching a scheme in an NFO. It is a one-time expense. Schemes launched before the commencement of the Securities and Exchange Board of India (Mutual Funds) (Amendment) Regulations, 2008 had to bear the initial issue expenses up to 6% of the amount mobilized. This has been discontinued and the initial issue expenses are now borne by the AMC.

Recurring Expenses are the fund running expenses incurred to manage the money raised from the investors. These can be charged to the scheme. Since the recurring expenses drag down the NAV, SEBI has laid down the types expenses, which can be charged to the scheme and the limits to such expenses. An indicative list is as follows:

- Fees of various service providers, such as Trustees, AMC, Registrar & Transfer Agents, Custodian, & Auditor

- Marketing and selling expenses including scheme advertising and commission to the distributors
- Expenses on statutory investor communication, account statements, dividend / redemption cheques / warrants
- Listing fees and Depository fees
- Insurance premium paid by the fund
- In case of Gold ETFs, the cost of storage and handling of gold, in case of Capital Protection funds, the cost of credit rating and in the case of Real estate mutual funds, the cost of insurance premia and maintenance of real estate assets.
- Service tax
- Winding up costs for terminating a fund or scheme

Expenses that are not permitted to be charged to the scheme shall be borne by the AMC or sponsors. Brokerage and transaction cost incurred for the purpose of execution of trade may be capitalized to the extent of 0.12% for cash market transactions and0.05% for derivatives transactions respectively. Any payment towards brokerage and transaction cost, over and above the said percentage may be charged to the scheme within the maximum limit of Total Expense Ratio (TER). Expenditure in excess of the said prescribed total expense ratio limit (including brokerage and transaction cost, if any) has to be borne by the AMC or by the trustee or sponsors.

Other provisions with respect to service tax are as follows:

- o Mutual funds /AMCs may charge service tax on investment and advisory fees to the scheme in addition to the maximum limit of total expense allowed for the scheme
- o Service tax on expenses other than investment and advisory fees, if any, is to be borne by the scheme within the maximum limit of total expense allowed for the scheme.
- o Service tax on brokerage and transaction cost paid for execution of trade, if any, must be within the prescribed total expense limit for the scheme, as discussed earlier.

The following expenses *cannot* be charged to the scheme:

- Penalties and fines for infraction of laws.
- Interest on delayed payment to the unit holders.
- Legal, marketing, publication and other general expenses not attributable to any scheme(s).
- Fund Accounting Fees.

- Expenses on investment management/general management.
- Expenses on general administration, corporate advertising and infrastructure costs.
- Depreciation on fixed assets and software development expenses.

6.1.7 Recurring Expense Limits

SEBI has stipulated the following annual limits on recurring expenses (including management fees) for schemes other than index schemes:

Net Assets (Rs crore)	Equity Schemes	Debt Schemes
Upto Rs 100 crore	2.50%	2.25%
Next Rs 300 crore	2.25%	2.00%
Next Rs 300 crore	2.00%	1.75%
Excess over Rs 700 crore	1.75%	1.50%

In case of debt funds the above percentages shall be lesser by 0.25%. The above percentages are to be calculated on the average daily net assets of the scheme.

The expense limits (including management fees) for index schemes (including Exchange Traded Funds) is 1.5% of average net assets.

In case of a fund of funds scheme, the total expenses of the scheme including weighted average of charges levied by the underlying schemes shall not exceed 2.50 per cent of the average daily net assets of the scheme.

Further, if the new inflows from beyond top 15 cities[4] are at least (a) 30% of gross new inflows in the scheme or (b) 15% of the average assets under management (year to date) of the scheme, whichever is higher, funds can charge additional expense of up to 30 basis points on daily net assets of the scheme.

In case inflows from beyond top 15 cities is less than the higher of (a) or (b) above, additional total expense on daily net assets of the scheme shall be charged as follows:

[4] Top 15 cities based on Association of Mutual Funds in India (AMFI) data on 'AUM by Geography – Consolidated Data for Mutual Fund Industry' as at the end of the previous financial year.

$$\frac{\text{Daily net assets X 30 basis points X New inflows from beyond top 15 cities}}{\text{365* X Higher of (a) or (b) above}}$$

* 366, where applicable

The additional TER on account of inflows from beyond top 15 cities so charged shall be clawed back in case the same is redeemed within a period of 1 year from the date of investment. The additional TER charged must be utilised for distribution expenses incurred for bringing inflows from such cities.

Mutual funds are also allowed to charge an additional expense not exceeding 20bps of the average daily net assets under the various heads of permitted recurring expenses.

Service tax on fees paid on investment management and advisory fees shall be charged to the scheme in addition to the overall limits specified earlier. Service tax paid on any other fees shall be charged to the scheme within the overall limits specified. Service tax on exit load, if any, shall be deducted from the exit load and the net amount shall be credited to the scheme.

Mutual funds/AMCs shall launch new schemes under a single plan and ensure that all new investors are subject to single expense structure. Investors, who have already invested as per earlier expense structures based on amount of investment in different plans (such as retail, institutional, super-institutional), will be subject to single expense structure for all fresh subscription. These plans will continue till such investors remain invested in the plan.

Further, investor also has the option of investing through direct plans. Since the direct plans do not entail distributor commissions, they may have a lower expense ratio.

6.1.8 Dividends & Distributable Reserves

As seen earlier, in the calculation of net assets, investments are taken at their market value. This is done, to ensure that sale and re-purchase transactions are effected at the true worth of the unit, including the gains on the investment portfolio.

Similarly, it was seen that income and expense are accounted on the basis of accrual principle. Therefore, even though they may not have been received or paid, they are accrued as income or expense, if they relate to a period until the accounting date.

Unlike accrued income (which is receivable - it is only a question of time) and accrued expense (which is payable - it is only a question of time), valuation gains in the scheme's portfolio may never get translated into real gains - it is NOT just a question of time. The securities need to be sold, for the scheme to be sure about the capital gains i.e. the capital gains need to be *realized*.

Since the investments in the portfolio are not yet sold, the gains in them are on paper - they are not *realised*. They will be realized, when those investments are sold.

SEBI guidelines stipulate that dividends can be paid out of *distributable reserves.* In the calculation of distributable reserves:

- All the profits earned (based on accrual of income and expenses as detailed above) are treated as available for distribution.
- Valuation gains are ignored. But valuation losses need to be adjusted against the profits.
- That portion of sale price on new units, which is attributable to valuation gains, is not available as a distributable reserve.

This conservative approach to calculating distributable reserves ensures that dividend is paid out of real and realized profits, after providing for all possible losses.

The trustees shall decide the quantum of dividend and the record date. The record date is the date used as cut-off to determine the eligibility to receive the dividend by investors based on the register of unit holders. The NAV will be adjusted at the end of the record date to reflect the pay out of dividend. Within one day of the trustees' decision, the AMC shall issue a public communication giving the details of the dividend including the record date. The record date shall be five calendar days from the issue of the notice by the AMC. The public notice should clearly state that the NAV will decline pursuant to the dividend pay-out and any statutory levy, if applicable.

The need for notice is not necessary for schemes/plans such as liquid schemes or other debt schemes with dividend distribution frequency ranging from daily to monthly. The SID should have requisite disclosures in this regard. Listed schemes shall follow the requirements stipulated in the listing agreement for the purpose of declaring and distributing dividends.

6.1.9 Key Accounting and Reporting Requirements

- The accounts of the schemes need to be maintained distinct from the accounts of the AMC. The auditor for the AMC has to be different from that of the schemes.
- Norms are prescribed on when interest, dividend, bonus issues, rights issues etc. should be reflected for in the accounts.
- NAV is to be calculated upto 4 decimal places in the case of index funds, liquid funds and other debt funds.
- NAV for equity and balanced funds is to be calculated upto at least 2 decimal places.
- Investors can hold their units even in a fraction of 1 unit. However, current stock exchange trading systems may restrict transacting on the exchange to whole units.
- The frequency of disclosures of NAV, Portfolio and Scheme accounts was discussed in Chapter 3.

6.2 Valuation

A mutual fund scheme invests the investors' money in a portfolio of securities created and managed based on the investment objective and strategy of the scheme. The investments include securities, money market instruments, privately placed debentures, securitised debt instruments, gold and gold related instruments, real estate assets and infrastructure debt instruments and assets. The NAV of the scheme will depend upon the value of this portfolio, which in turn, depends upon the value of the securities held in it. The valuation of these securities to determine the net asset value has to be done in accordance with the valuation norms laid down by SEBI and AMFI. This includes the following norms:

- A traded security shall be valued at the last traded price on the principle stock exchange where it is traded. Wherever a security, say, Infosys share, is traded in the market on the date of valuation, its closing price on that date is taken as the value of the security in the portfolio. Thus, the number of Infosys shares in the portfolio (say, 1,000) multiplied by its closing price (say, Rs 2,700), gives the valuation of Infosys shares in the portfolio (1,000 shares X Rs 2,700 = Rs 27,00,000). Similarly, every security in the portfolio is to be valued. All money market and debt instruments with residual maturity upto 60 days shall be valued at the weighted average price on the valuation date.

- A non-traded security is a security that has not been traded for thirty days prior to the valuation date. A thinly-traded security is one where the volume and value traded in a month less than that specified. Currently, for equity shares this is at Rs.5 lakhs in value and 50,000 in volume. A debt instrument (other than government security) is considered thinly traded if on the valuation date there is no individual trade in the security in the market lots on the principle stock exchange. A non-traded or thinly traded equity instrument may be valued using the capitalization of earnings method, using the PE ratio of comparable traded securities for capitalization after discounting it for lower liquidity.

- A non-traded or thinly traded debt security is valued on the basis of the yield matrix prepared by an authorized valuation agency. The yield matrix estimates the yield for different debt securities based on the credit rating of the security and its maturity profile. When money market instruments and debt securities with residual maturity of up to 60days are not traded on a particular day, they shall be valued on amortization basis. If the residual maturity is more than 60 days, then in the even they are not traded they shall be valued on the basis of a yield matrix obtained from agencies entrusted to do so by AMFI.

- There are detailed norms on when a security is to be treated as a Non-Performing Asset (NPA), how much is to be written off (treated as a loss) at various points of time, when the amounts written off can be added back to the value of the asset (treated as income), and when a NPA can be treated as a Standard Asset.

- Where security that is not traded or thinly traded, represents more than 5% of the net assets of a scheme, an independent valuer has to be appointed.
- Illiquid securities, defined as non-traded, thinly-traded and unlisted equity shares, shall not exceed 15% of the total assets of the scheme. Any excess over 15% shall be assigned zero value.
- The value of the gold held by a gold ETF will be valued at the AM fixing price of London Bullion Market Association (LBMA) in US dollars per troy ounce for gold having a fineness of 995.0 per thousand.
- The AMC will constitute an in-house valuation committee consisting of senior executives from accounting, fund management and compliance departments to periodically review the systems and practices for valuation of securities.

6.3 Taxation

6.3.1 Taxability of Mutual Fund

A mutual fund trust is exempt from tax on its income and earnings under section 10(23D) of the Income Tax Act. Since the returns of the mutual fund are passed through its investors, the returns are taxed in the hands of the investors. A mutual fund distributes the returns to the investors in the form of periodic dividends and appreciation in the value of the units. The tax liability will depend upon the type of mutual fund scheme, the type of investor and the period of holding.

The definitions under the Income Tax Act, for the purpose are as follows:

Equity-oriented scheme is a mutual fund scheme where at least 65% of the assets are invested in equity shares of domestic companies. For calculating this percentage, first the average of opening and closing percentage is calculated for each month. Then the average of such value is taken for the 12 months in the financial year.

For *Money market mutual funds / Liquid schemes*, income tax goes by the SEBI definition, which says that such schemes are set up with the objective of investing exclusively in money market instruments (i.e. short term debt securities).

6.3.2 Securities Transaction Tax (STT)

This is a tax on the value of transactions in equity shares, derivatives and equity mutual fund units. Applicability is as follows:

<u>On equity-oriented schemes of mutual funds</u>

On purchase of equity shares in stock exchange	0.1%

On sale of equity shares in stock exchange	0.1%
On sale of futures in stock exchange	0.01%
On sale of options in stock exchange	0.017%

On investors in equity oriented schemes of mutual fund

On purchase of the units in stock exchange	Nil
On sale of the units in stock exchange	0.001%
On re-purchase of units (by fund)	0.001%

STT is not applicable on transactions in *debt or debt-oriented* mutual fund (including liquid fund) units.

6.3.3 Additional Tax on Income Distributed

Dividends are tax-free in the hands of the investor. However, there is a tax on dividend distributed by debt-oriented mutual fund schemes which is paid by the mutual fund. Applicability of Dividend Distribution Tax (DDT) is as follows:

Residential Individuals and HUF : 25% + 12% Surcharge + 3% Education Cess = 28.84%

NRIs : 25% + 12% Surcharge + 3% Education Cess = 28.84%

Domestic Companies : 30% + 12% Surcharge + 3% Education Cess = 34.608%

This additional tax on income distributed (referred to in the market as *dividend distribution tax)* is not payable on dividend distributed by equity-oriented mutual fund schemes.

6.3.4 Capital Gains Tax

Capital Gain is the difference between sale price and acquisition cost of the investment. Since mutual funds are exempt from tax, the schemes do not pay a tax on the capital gains they earn.

Investors in mutual fund schemes however need to pay a tax on their capital gains as follows:

Equity-oriented schemes

- Nil – on LTCG or Long Term Capital Gains (i.e. if investment was held for more than a year) arising out of transactions, where STT has been paid. This applies to all categories of investors- resident individuals, domestic companies and NRIs.

- 15% plus surcharge as applicable plus education cess @3% – on STCG or Short Term Capital Gains (i.e. if investment was held for 1 year or less) arising out of transactions, where STT has been paid for all categories of investors i.e. resident investors, domestic companies and NRIs. Surcharge @ 12% is applicable for individual investors where the income exceeds Rs.1 crore. Surcharge @ of 7% is applicable for unit holder companies where the income exceeds Rs.1 cr but is less than one Rs.10 cr. Surcharge is levied @ 12% where the income exceeds Rs. 10 crores. Tax is deducted at source for NRI investors alone.

- Where STT is not paid, the taxation of capital gains from equity products is similar to that of debt-oriented schemes

Debt-oriented schemes

- If investment is held for three years or less, the capital gain is treated as Short Term Capital Gains or STCG. It is added to the income of the investor and gets taxed at the marginal rate of taxation applicable to the investor. Thus, STCG gets taxed as per the tax slabs applicable for the investor.

- If investment is held for more than three years, the capital gain is treated as Long Term Capital Gain or LTCG. Investor is entitled to the benefit of indexation on LTCG and the capital gains post-indexation is taxed @20% plus applicable surcharge and 3% cess.

Indexation means that the cost of acquisition is adjusted upwards to reflect the impact of inflation. The government comes out with an inflation index number for every financial year to facilitate this calculation. Indexation benefit is available only in case of long term capital gains and not short term capital gains. Tax is payable on long-term capital gains, after indexation, at 20% plus surcharge plus education cess.

For example, if the investor bought units of a debt-oriented mutual fund scheme at Rs 10 and sold them at Rs 15, after a period of 3 years. Assume the government's inflation index number was 400 for the year in which the units were bought; and 440 for the year in which the units were sold. The investor would need to pay tax based on indexation.

Indexed cost of acquisition is Rs 10 X 440 ÷ 400 i.e. Rs 11. The capital gains post indexation is Rs 15 minus Rs 11 i.e. Rs 4 per unit. 20% tax on this would mean a tax of Rs 0.80 per unit. Surcharge and education cess is extra. For individual investors (including NRIs) surcharge @ 12% is applicable where the income exceeds Rs.1 crore. Surcharge @ of 7% is applicable for unit holder companies where the income exceeds Rs.1 cr but is less than one Rs.10 cr. Surcharge is levied @ 12% where the income exceeds Rs. 10 crores. Tax is deducted at source for NRI investors alone.

An advantage of for an investor in the growth option of a debt scheme is that there is no tax on the income till the time the capital gain is booked. Even this capital gain on exit from the units may get beneficial treatment as long term capital gain, if held for more than 3 years from indexation. Since dividend is not declared in a growth option, the investor can avoid the income distribution tax completely, even in a debt scheme. Income distribution tax is not applicable to equity schemes in any case.

6.3.5 Tax Deducted at Source (TDS)

There is no TDS on the dividend distribution or re-purchase proceeds to resident investors. However, for certain cases of non-resident investments, with-holding tax is applicable. The income tax regulations prescribe different rates of withholding tax, depending on the nature of the investor (Indian / Foreign and Individual / Institutional), nature of investment (equity / debt) and nature of the income (dividend / capital gain).

Further, Government of India has entered into Double Taxation Avoidance Agreements (DTAA) with several countries. These agreements too, specify rates for Withholding Tax.

The withholding tax applicable for non-resident investors is the lower of the rate specified in the income tax regulations or the tax specified in the DTAA of the country where the investor is resident. The investor, however, will need to satisfy the mutual fund that he is entitled to such concessional rate as is specified in the DTAA.

6.3.6 Taxability of Mutual Fund Investor

Based on the above discussions, it can be summarized that:

- An investor in an equity-oriented mutual fund scheme
  - Would pay STT on the value of the transactions of sale (0.001%) of units in the stock exchange; or on re-purchase (0.001%) of the units by the fund
  - Would be exempt from capital gains tax, if the units were held for more than a year
  - Would pay capital gains tax at 15% plus surcharge and education cess, if the units were held for 1 year or less
  - Will receive any dividend free of tax; the scheme too will not incur any tax on the dividend distribution.
- An investor in a debt-oriented mutual fund scheme
  - Would not bear any STT
  - Would bear a tax on long term capital gains at 20% with indexation
  - Would bear a tax on short term capital gains, as per the investor’s tax slab.
  - Will receive any dividend free of tax; but the scheme would have paid a tax on the dividend distribution. This can be avoided by opting for the growth option of a debt scheme.

6.3.7 Setting off Gains and Losses under Income Tax Act

The Income Tax Act provides for taxation under various heads of income viz. salaries, income from house property, profits & gains of business or profession, capital gains, and income from other sources. In the normal course, one would expect that a loss in one head of income can be adjusted ("set off") against gains in another head of income, since a person is liable to pay tax on the total income for the year. However, there are limitations to such set-off. A few key provisions here are:

- Capital loss, short term or long term, cannot be set off against any other head of income (e.g. salaries)
- Short term capital loss is to be set off against short term capital gain or long term capital gain
- Long term capital loss can only be set off against long term capital gain
- Since long term capital gains arising out of equity-oriented mutual fund units is exempt from tax, long term capital loss arising out of such transactions is not available for set off.

Several other factors go into taxation or tax exemption. If one is not an expert on the subject, it would be better to engage the services of a tax consultant.

6.3.8 Limitations on Set-off in case of Mutual Fund Dividends

- When a dividend is paid, the NAV (ex-dividend NAV) goes down.
- This dividend is exempt from tax at the hands of investors
- Capital loss may be available for set off against Capital gains.

A potential tax avoidance approach, called *dividend stripping*, worked as follows:

- Investors would buy units, based on advance information that a dividend would be paid.
- They would receive the dividend as a tax-exempt income. Equity schemes, as seen earlier, do not bear the additional tax on income distributed.
- After receiving the dividend, they would sell the units. Since the ex-dividend NAV would be lower, they would book a capital loss (with the intention of setting it off against some other capital gain).

In order to plug this loophole, it is provided that:

- if, an investor buys units within 3 months prior to the record date for a dividend, and
- sells those units within 9 months after the record date,

any capital loss from the transaction would not be allowed to be set off against other capital gains of the investor, up to the value of the dividend income exempted.

Suppose the record date is April 1, 2014, for dividend of Rs1 per unit for a scheme. Assume an investor buys units at Rs15 within 3 months prior (i.e. January to March 2014) and sells those units at Rs12 within 9 months after the record date (i.e. April to December 2014).

In the normal course, capital loss (short term, because it is held for less than 1 year) of Rs15 minus Rs12 i.e. Rs3 per unit would be available for set off against other capital gain (long term or short term) of the investor. Further, the dividend of Rs1 would be tax-exempt in the hands of the investor.

On account of the limitations on set-off, the capital loss available for setting off against other capital gain would be restricted to Rs3 minus Rs1 i.e. Rs2 per unit.

In the above case, if the unit-holder wanted the entire capital loss to be available for set off, then either the units should have been bought before Jan 1, 2014, or they should be sold after December 31, 2014. Any intelligent investor knows that it would be better to adopt an investment strategy based on market scenario, and bear the relevant tax, instead of allowing tax optimization to drive the investment strategy.

6.3.9 Limitations on Set-off in case of Bonus Units

Suppose an investor buys units of a scheme at Rs30. Thereafter, the scheme declares a 1:1 bonus issue i.e. the investor receives 1 new unit, for every unit that was bought earlier. Logically, the NAV of the scheme will halve, and it is likely that the units would now have a value of Rs15. At this stage, if the investor sells the original unit at Rs 15, a loss of Rs 15 is incurred [Rs30 (original purchase price for the Units) minus Rs15 (currently realised)].

However, such capital loss is not available for setting off against capital gains, if the original units were bought within a period of 3 months prior to the record date for the bonus issue and sold off within a period of 9 months after the record date.

In such cases, the capital loss will be treated as the cost of acquisition of the bonus units.

6.3.10 Wealth Tax

Investments in mutual fund units are exempt from Wealth Tax. This is irrespective of where the fund invests. Although investment in physical gold or real estate may attract wealth tax in case of direct investors, investments in Gold ETF and real estate mutual funds are exempt from wealth tax.

Sample Questions

1. Net assets of a scheme are nothing but its investment portfolio.

a. True
b. **False**

2. The difference between NAV and re-purchase price is _______.

a. Entry Load
b. **Exit Load**
c. Expense
d. Dividend Stripping

3. NAV of income funds is to be calculated upto ___ decimals.

a. **4**
b. 3
c. 2
d. 1

4. Securities Transaction Tax is applicable to Equity Schemes.

a. True
b. False

5. Wealth tax is payable at the applicable rates on equity mutual fund units.

a. True
b. **False**

6. For a debt scheme with corpus of Rs. 250 cr, what is the maximum amount that can be charged by the AMC as recurring expense, if all moneys have come from the Top 15 cities?

a. Rs. 5.625 cr
b. Rs. 5 cr
c. Rs. 4.625 cr
d. **Rs. 5.25 cr**

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CHAPTER 7: INVESTOR SERVICES

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Eligibility criteria for investment in mutual funds in India
- Documentation requirements for mutual fund investors
- Different kind of transactions in mutual funds
- Systematic transactions in mutual funds

7.1 Mutual Fund Investors

7.1.1 Eligibility to Invest

The following are eligible to purchase Units of most schemes:

<u>Individual Investors</u>
They invest for their personal benefit or the benefit of their family. Examples:

- Resident Indian adult individuals, above the age of 18: They can invest, either singly or jointly (not exceeding three names)

- Minors i.e. persons below the age of 18: Since they are not legally eligible to contract, they need to invest through their guardians.

- Hindu Undivided Families (HUFs): Here, family members pool the family money (inherited) for investments. The head of the family (called "Karta") invests on behalf of the family. Against his name in the application, he would add the letters "HUF" to show that the investment belongs to the family.

- Non-Resident Indians (NRIs) /Persons of Indian origin (PIO) resident abroad: Indian citizens, who are working abroad, and their family residing abroad, are typical NRIs who invest in India. Some Indians go on to become citizens of foreign countries such as US, Canada, New Zealand etc. Since India does not permit dual citizenship, they need to give up their Indian citizenship. However, their status as erstwhile Indians, entitles them to invest in mutual fund schemes on full repatriation or non-repatriation basis. As part of the documentation, they will need to provide their PIO (Person of Indian Origin) Card / OCI (Overseas Citizenship of India) Card.

  NRI / PIO resident abroad have the facility of investing on repatriable basis i.e. when they sell the investment, the sale proceeds can be transferred abroad. Alternatively, they can invest on non-repatriable basis, in which case the proceeds from the sale of those investments cannot be remitted abroad. The conditions related to making payments for repatriable investments are discussed later in this Chapter.

- Foreign investors can invest in equity schemes of MFs registered with SEBI after completing KYC process.

Non-individual Investors

Here, the investments are made by institutions, and individuals who are authorized to do so sign the documents on behalf of organizations / institutions they represent, such as:

- Companies / corporate bodies, registered in India
- Registered Societies and Co-operative Societies
- Trustees of Religious and Charitable Trusts
- Trustees of private trusts
- Partner(s) of Partnership Firms
- Association of Persons or Body of Individuals, whether incorporated or not
- Banks (including Co-operative Banks and Regional Rural Banks) and Financial Institutions and Investment Institutions
- Other Mutual Funds registered with SEBI
- Foreign Institutional Investors (FIIs) registered with SEBI
- International Multilateral Agencies approved by the Government of India
- Army/Navy/Air Force, Para-Military Units and other eligible institutions
- Scientific and Industrial Research Organizations
- Universities and Educational Institutions

SEBI and RBI circulars dated August 9, 2011 have allowed Qualified Foreign Investors (QFIs) who meet KYC requirements to invest in equity and debt schemes of Mutual Funds through two routes:

- Direct route - Holding MF units in demat account through a SEBI registered depository participant (DP).
- Indirect route- Holding MF units via Unit Confirmation Receipt (UCR)

7.1.2 Sources of Information on Eligibility

The individual investors eligible to invest as detailed above, can invest in any mutual fund scheme, unless the mutual fund comes out with a specific scheme, or a plan within a scheme, that is not intended for any category of investors.

The non-individual investors eligible to invest as detailed above, can invest in a mutual fund. However, it is a good practice to check the 'Who can Invest' section of the SID, especially for a first time investor.

Further, in some schemes, only specific classes of non-individual investors are permitted. For instance:

- Some gilt schemes have specific plans, which are open only for Provident Funds, Superannuation and Gratuity Funds, Pension Funds, Religious and Charitable Trusts and Private Trusts.

7.2 KYC Requirements for Mutual Fund Investors

All investors, both individual and non-individual, including joint holders, NRIs, PoA holders and guardians in the case of minors have to be KYC compliant, irrespective of the investment value. The KYC process involves establishing the identity and address of the investor as required under the Anti-money Laundering Laws. The application for investment must be accompanied by the acknowledgement for having completed the KYC process issued by the KYC registration agency (KRA).

Broadly, mutual fund investors need to submit the following documents to the distributor or other capital market intermediary registered with SEBI, such as stock broker and depository participant. The information is updated in the central system of the KRA:

- Proof of Identity such as PAN card, Voter's identity card, Driver's licence and other photo-identity.
- Proof of Address such as passport, bank account statement, utility bill and other specified documents.
- PAN Card
- Photograph

SEBI has also instituted a framework of Centralised KYC Registration Agencies (KRAs) for the benefit of investors. This was discussed in Chapter 2. Appendix 5 (for Individuals), Appendix 6 (for non-Individuals) and Appendix 7 (for change in details of Individuals) are the relevant forms.

Centralised KRAs have made the KYC process simpler for investors. Mutual funds, depositories, registrars and transfer agents, KYD compliant mutual fund distributors and brokers are authorised to facilitate the KYC documentation of investors. This entails the following:

- The requisite form is to be filed along with supporting documents.
- The supporting documents will be verified with the original. Alternatively, the investor can provide a True Copy attested by a Notary Public, Gazetted Officer or Manager of a Scheduled Commercial Bank.
- The original is returned to the investor, after verification, while the forms and supporting documents are uploaded in the server of any centralised KRA.
- The intermediaries mentioned above are also authorised to perform an In Person Verification (IPV) of the investor, which is mandatory.

Once these processes are completed and the details are uploaded on the KRA's servers, the KYC process is complete. The investor does not need any further KYC for dealing in any part of the securities market (depository, stock exchange transactions, mutual fund transactions etc.).

With a view to bring about operational flexibility and in order to ease the PAN verification process, SEBI has provided that market intermediaries may verify the PAN of their clients online at the Income Tax website without insisting on the original PAN card, provided that the client has presented a document for Proof of Identity other than the PAN card.

Similarly, in the event of change of address or any other information, the mutual fund investor needs to fill the standard form and follow the prescribed process only once, with any of the intermediaries mentioned above. Based on that, the information will be updated with all the mutual funds and other capital market related parties where the investor has invested.

Where investment is made by a minor, KYC requirements have to be complied with by the Guardian. On becoming a major, the erstwhile minor investor has to complete the KYC process and provide the acknowledgement to the mutual fund.

In the case of investments by a Power of Attorney holder on behalf of an investor, KYC requirements have to be complied with, by both, investor and PoA holder.

In consultation with Unique Identification Authority of India (UIDAI) and the market participants, it has now been decided to accept e-KYC service launched by UIDAI also, as a valid process for KYC verification. The information containing relevant client details and photograph made available from UIDAI as a result of e-KYC process shall be treated as sufficient proof of Identity and Address of the client. However, the client shall have to authorize the intermediary to access his data through UIDAI system.

7.3 PAN Requirements and Micro-SIPs

PAN Card is compulsory for all mutual fund investments. Exception has been made for Micro-SIPs i.e. SIPs where annual investment (12 month rolling or April-March financial year) does not exceed Rs 50,000. Similarly, as discussed later in this chapter, small investors investing in cash, upto Rs. 50,000 per mutual fund per financial year do not need to provide PAN Card. Rs. 50,000 is a composite limit for the small investor's Micro-SIP and lump sum investments together.

Micro-SIP investment by individuals, minors and sole-proprietary firms are exempted from the requirement of PAN card. Instead, the investors (including joint holders) can submit any one of the following PHOTO IDENTIFICATION documents along with Micro SIP applications:

- Voter Identity Card
- Driving License
- Government / Defense identification card
- Passport
- Photo Ration Card
- Photo Debit Card (Credit card not included because it may not be backed up by a bank account).
- Employee ID cards issued by companies registered with Registrar of Companies)
- Photo Identification issued by Bank Managers of Scheduled Commercial Banks / Gazetted Officer / Elected Representatives to the Legislative Assembly / Parliament
- ID card issued to employees of Scheduled Commercial / State /District Co-operative Banks.
- Senior Citizen / Freedom Fighter ID card issued by Government.
- Cards issued by Universities / deemed Universities or institutes under statutes like Institute of Chartered Accountants of India, Institute of Cost Accountants of India and Institute of Company Secretaries of India.
- Permanent Retirement Account No (PRAN) card issued to National Pension System (NPS) subscribers by CRA (NSDL).
- Any other photo ID card issued by Central Government / State Governments /Municipal authorities / Government organizations like ESIC / EPFO.

The Document must be current and valid. Document copy shall be self-attested by the investor / attested by the ARN holder mentioning the ARN number.

Investors have to give a declaration stating that they do not have any existing Micro SIPs which together with the current application will result in aggregate investments exceeding Rs. 50,000 in a year.

It may be noted that the relaxation in documentation requirements for micro-SIPs is not available for HUFs and non-individuals. Such relaxation is available for NRIs, but not PIOs.

7.4 Additional Documentation Requirements applicable for Institutional Investors

Since institutional investors are not natural persons, authorised individuals invest on behalf of the institution. Therefore, the following additional documents are essential:

- Eligibility for the investing institution to invest. For instance, a company / trust is eligible to invest under the laws of the country, but the company's own incorporation documents (Memorandum of Association and Articles of Association or Trust Deed) may not have provided for such investments. The company / trust cannot invest if its incorporation documents do not provide for investments of this type.

  Similarly, in some states, permission of the Charity Commissioner is necessary, before Religious and Charitable Trusts can invest.

- Authorisation for the investing institution to invest. This is typically in the form of a Board Resolution.

- Authorisation for the official to sign the documents on behalf of the investing institution. This again is provided for in the Board Resolution. In case of other non-individual investors, too the list of authorised signatories would be required. The mutual fund can allow transactions only if the transaction form / slip carries the signature of any (one or more, as required) of the authorised signatories.

- SEBI has mandated that investors other than individuals have to provide details of the 'Ultimate Beneficial Owner' (UBO) of the investments and submit documents to establish their identity of such UBOs through any of the identity proofs acceptable under the KYC norms. An UBO of a company is one who owns or is entitled to more than 25% of its shares or profits, more than 15% in case of partnerships and body of persons. In case of a trust, this includes the settler, the trustees, the beneficiaries who are entitled to 15% or more of the benefits. The UBO requirements are not applicable to listed companies or subsidiaries of the same.

These documentation requirements for institutional investors are in addition to the normal KYC documentation, discussed earlier.

7.5 Demat Account

Dematerialisation is a process whereby an investor's holding of investments in physical form (paper), is converted into a digital record. Benefit of holding investments in demat form is that investors' purchase and sale of investments get automatically added or subtracted from their investment demat account, without having to execute cumbersome paperwork. Settlement of most transactions in the stock exchange needs to be compulsorily done in demat form.

In order to avail this facility, the investor needs to open a demat account with a depository participant.

The benefits of demat facility for mutual fund investors has increased, with National Stock Exchange and Bombay Stock Exchange making available screen-based platforms for purchase and sale of mutual fund schemes.

Mutual funds are required to provide investors the option to hold the units in demat form. The mutual fund has to obtain an ISIN for each option of a scheme and make the information available in all the account statements sent to the investor. The application form for all schemes must have an option to provide the demat account details in case the investor chooses to hold the units in demat form. The demat facility is typically initiated by the mutual fund, which would tie up with a Depository (like National Securities Depository Ltd or Central Depository Securities Ltd). On the basis of this tie-up, investors can open a demat account with a Depository Participant and dematerialize their investment holding i.e. convert their physical units into demat units. Usual KYC documentation will be required for opening the account. However, once the KYC including IPV is performed for opening a demat account, no separate KYC is required to be done by the AMC or distributor or any other capital market intermediary. If KYC has already been done by any other capital market intermediary, then the DP will not insist on another KYC.

Investors can also choose to get their existing units (as represented by the statement of account) dematerialized. On dematerialisation, the investor's unit-holding will be added to his / her demat account. As and when the investor sells the unit-holding, the relevant number of units will be reduced from the investor's demat account. The investor's benefits from a demat account are as follows:

- Less paperwork in buying or selling the Units, and correspondingly, accepting or giving delivery of the Units.
- Direct credit of bonus and rights units that the investor is entitled to, into the investor's demat account.

- Change of address or other details need to be given only to the Depository Participant, instead of separately to every company / mutual fund where the investor has invested and holds demat units.
- Consolidate all investments in mutual funds, direct equity, debentures and others under one account.

The investor also has the option to convert the demat units into physical form. This process is called *re-materialisation.*

7.6 Transactions with Mutual Funds

7.6.1 Fresh Purchase

Fresh purchase or initial purchase of mutual fund units in a scheme can be made during the new fund offer (NFO) period or even subsequently in an open-ended scheme, during the open offer period. Application forms are available with offices of AMCs, distributors and ISCs. They are also downloadable from the websites of the AMCs concerned.

The normal application form, with KIM attached, is designed for fresh purchases i.e. instances where the investor does not have an investment account (technically called "folio") with the specific mutual fund. The mutual fund would need the completed application form with the prescribed documentation and the requisite investment amount, to allot an investment folio in the name of the investor. The information provided in the application form is used to create the investor record or folio with the mutual fund. The folio is created in the name of the first holder who is the primary investor. This includes personal information such as name(s), identity proof and KYC compliance and signatures of all the holder(s), address and communication details of the first holder, bank account details of the first holder, mode of holding and operating the account and choice of plan and option in the scheme. All benefits of the investments such as dividends and redemption payments and tax benefits goes to the first holder. The folio can be operated singly by the first holder, jointly by all the holders or by either or survivor.

An investment made for a minor (less than 18 years) is done through a guardian who complies with the KYC and PAN requirements and all other formalities as if the investment was for themselves. The proof of age has to be given along with the application. An investment for a minor cannot have joint holders. On attaining majority, the information of the erstwhile minor investor has to replace that of the guardian. KYC, PAN, Signature attested by banker and bank account details are updated in the folio. The guardian can no longer operate the folio.

Similarly, a folio operated under a Power of Attorney (PoA), requires the PoA holder to comply with the KYC and PAN requirements and a certified copy of the PoA to be submitted to the mutual fund before the holder can operate the folio. The grantor or investor can continue to operate the account despite granting a PoA. The PoA holder can conduct all transactions except make or change nominations.

While investing, the investor needs to confirm that the investment is above the minimum investment limit set by the mutual fund for the scheme.

7.6.2 Additional Purchases

Once an investor has a folio with a mutual fund, subsequent investments with the same mutual fund do not call for the full application form and documentation. Only a transaction slip needs to be filled giving the folio number, and submitted with the requisite payment. A transaction slip can be used to make additional purchases in an open-ended scheme in which the investor has already invested. It can also be used to make fresh purchases in another scheme of the same mutual fund.

Most mutual funds send a transaction slip (with the investor's folio number pre-printed) along with the Statement of Account. Alternatively, blank transaction slip (without pre-printed folio number), which is available with branches of the AMC, distributors and ISCs, or downloadable from the net, can be used.

The investor needs to confirm that the investment is above the minimum investment limit set by the mutual fund for additional purchases in the scheme.

7.6.3 Online Transactions

Investors can conduct their mutual fund transactions online. The investor is required to fill the requisite details in an application form. Based on this, the investor would be allotted a user name and password (Personal Identification Number – PIN). This can be used by the investor to make additional purchases of units in the mutual fund, or to request re-purchase of the units held in the mutual fund.

Some distributors too, through their websites, facilitate online transactions by investors.

For investors directly investing into mutual funds without routing through a distributor, Mutual funds/ AMCs provide a separate plan called "direct plan". Units under this plan have a lower expense ratio and have a separate NAV. However, if investors use the online platforms provided by distributors they are not considered as a direct investment.

7.6.4 Payment Mechanism for Purchase / Additional purchase

Payment for mutual fund purchases need to be made through the banking channel modes that have been approved by the regulators. This includes

Cheque / Demand Draft (DD): Application forms for fresh investment / transaction slip for additional purchase is normally accompanied by one of these instruments, drawn in favour of the scheme in which application is to be made.

Cheques are signed by the account holder, while DDs are signed by the banker. Generally, DDs are accepted only if the investor is from a location where there is no official collection centre for the application.

NRI / PIO applications need to be accompanied by cheque drawn on an NRO account (for non-repatriable investment) or NRE account (for repatriable investment). If payment from NRI is by DD, and investment is on repatriable basis, a banker's certificate will be required to the effect that the DD has come out of moneys remitted from abroad.

The payment instrument would need to be local i.e. cheque should be drawn on a local bank account. If it is drawn on an out-station bank account, then the bank should offer the facility of 'at par' payment in the location where the application form and cheque are submitted. If such an 'at par' facility is available, 'payable at par at …… (list of locations / all over India)' would be clearly mentioned in the face or back of the cheque. Cheques accompanying the investment application are to be signed by the investor and drawn on an account in which the first holder is an account holder. Third-party cheques are not accepted except in special cases. For instance, payment by Parents/Grand-Parents/Related Persons on behalf of a minor in consideration of natural love and affection or as gift for a value not exceeding Rs 50,000/- for each regular Purchase or per SIP instalment. 'Related Person' means any person investing on behalf of a minor in consideration of natural love and affection or as a gift. In such cases persons who make payment should be KYC Compliant and sign Third Party Declaration Form., Similarly, employer making payments on behalf of employee through payroll deductions, and custodian on behalf of FIIs are permitted third-party payments. AMCs are required to put checks and balances in place to verify such transactions.

Similarly, DD should clearly mention the place of payment as the location where the application form / transaction slip and payment instrument are being submitted.

The payment instrument should not be post-dated (except for future instalments under SIP), and not stale (i.e. cheque date should not be more than 3 months older than the date on which the cheque is to be banked).

Remittance can also be made directly to the bank account of the scheme through Real Time Gross Settlement (RTGS) / National Electronic Funds Transfer (NEFT) transfers (for transfers within India) or SWIFT transfer (for transfers from abroad). While RTGS transfers are instantaneous, NEFT transfers are batched together in the banking system, and effected at various times during the day. SWIFT transfers tend to pass through multiple banks in different geographies, and multiple levels within the same bank, resulting in delays. All banks and their branches are not enabled to provide electronic transfer facilities.

Before money is remitted directly to the mutual fund, it is advisable to get the proper bank account details from the AMC / distributor. The details of the mutual fund such as account number, IFSC code etc. are required to do an electronic transfer. The bank will generate a unique transaction reference number. The acknowledgement from the bank for the transfer request has to be appended along with the application as proof of transfer. The account number mentioned in the transfer instruction copy provided as proof should have the first holder as one of the account holders.

Electronic Clearing Service (ECS) / Standing Instructions are a convenient form of investment in a SIP. On the specified date, each month, the bank will automatically transfer money from the investor's account to the account of the mutual fund. The bank accepts 'Standing Instructions' (also called 'Direct Debit') if both investor and mutual fund have an account with the same bank. If the two accounts are in different bank, then ECS is used.

Application Supported by Blocked Amount (ASBA): This is a facility where the investment application is accompanied by an authorization to the bank to block the amount of the application money in the investor's bank account.

The benefit of ASBA is that the money goes out of the investor's bank account only on allotment. Until then, it keeps earning interest for the investor. Further, since the money transferred from the investor's bank account is the exact application money that is due on account of the allotment, the investor does not have to wait for any refund.

ASBA, which was originally envisaged for public issues in the capital market, has now been extended to mutual fund NFOs.

M-Banking i.e. mobile banking is nascent in India. Individual banks may impose per day fund transfer limits. Once people are comfortable with M-banking, this will become a convenient way to invest.

Mutual funds usually do not accept cash. Small investors, who may not be tax payers and may not have PAN/bank accounts, such as farmers, small traders/businessmen/workers are allowed cash transactions for purchase of units in mutual funds to the extent of Rs. 50,000/- per investor, per mutual fund, per financial year. This is subject to compliance with Prevention of Money Laundering Act, 2002 and SEBI Circulars on Anti Money Laundering (AML) and other applicable AML rules, regulations and guidelines.

Although investment can be made in cash, repayment in form of redemptions, dividend payments etc. can be only through the banking channel.

Apart from the above mentioned exception for small investors, application moneys need to come through normal banking channels, as detailed below.

7.6.5 Allotment of Units to the Investor

Since entry load is banned, units in an NFO are sold at the face value i.e. Rs10. So the investment amount divided by Rs 10 would give the number of units the investor has bought.

However, in case of subscription/purchase above Rs. 10,000/- for application sourced from a distributor, in case the distributor has opted to receive transaction charges, a transaction charge of Rs. 100 (in case of an existing investor) or Rs. 150 (in case of an investor other than an existing investor) shall be deducted from the investment amount.

The price at which units are sold to an investor as part of ongoing sales in an open-end scheme is the sale price, which in turn is the applicable NAV (which is discussed later in this unit under 'Cut-off Time') plus Entry Load (currently entry load is not permitted by regulation).

The investment amount divided by the sale price would give the number of units the investor has bought.

Thus, an investor who has invested Rs 12,000, in a scheme where the applicable sale price is Rs 12, will be allotted Rs 12,000 ÷ Rs 12 i.e. 1,000 units.

In a rights issue, the price at which the units are offered i.e. the rights price is clear at the time of investment. The investment amount divided by the rights price gives the number of units that the investor has bought.

It may however be noted that rights issues, which are common for shares, are less meaningful for units of mutual fund schemes.

In a bonus issue, the investor does not pay anything. The fund allots new units for free. Thus, in a 1:3 bonus issue, the investor is allotted 1 new unit (free) for every 3 units already held by the investor. Since the net assets of the scheme remain the same – only the number of units' increases - the NAV will get reduced proportionately and the value of the investor's holding does not change significantly as a result of the bonus issue.

7.6.6 Repurchase of Units

The investor in an open ended scheme can offer the units for repurchase to the mutual fund. The transaction slip would need to be filled out to effect the re-purchase. Investor has the option to decide on the repurchase amount (which is generally the case) or number of units offered for re-purchase. The re-purchase price is the applicable NAV (which is discussed later in this unit under 'Cut-off Time') less Exit Load.

If the investor has specified the re-purchase amount, then that amount divided by the re-purchase price would be the number of units that will be reduced from his folio.

If the investor has specified the re-purchase units, then those many units will be reduced from his folio; payment would be made equivalent to the number of units re-purchased, multiplied by the re-purchase price.

If, while effecting the re-purchase, the investment holding in the folio goes below the minimum limit for maintaining the folio set by the mutual fund for the scheme, then all the Units may be re-purchased and the investment folio of the investor would be closed.

7.6.7 Payment Mechanism for Repurchase of Units

The investor has various options for receiving the moneys, due to him from the scheme on re-purchase of Units:

Cheque: This is a traditional approach, where the receipt of money in the investor's bank account is delayed on account of the processes involved viz. time taken by the AMC to prepare and send the cheque, time taken by postal authorities / courier to deliver the cheque, time taken by the investor to deposit the cheque in the bank, and time taken by the banking system to transfer the proceeds to the investor's bank account.

Direct Credit: The investor can give instructions for the repurchase proceeds to be directly transferred to his bank account. This is much faster because the various processes mentioned earlier for payment by cheque, are obviated.

It may be noted that for non-resident investors, payment is made by the AMC in rupees. In case the investment has been made on repatriable basis, and the investor wishes to transfer the moneys abroad, the costs associated with converting the rupees into any foreign currency would be to the account of the investor.

Mutual funds provide investors the facility to register multiple bank accounts to facilitate receiving the redemption, dividends and any other pay outs from the fund. An individual investor can register up to five accounts and a non-individual investor, ten. The first holder of the folio must be an account holder in each of the accounts that are registered. One of the accounts is designated as the default account, and unless otherwise specified all credits are made to this account by the mutual fund. Investors can change the default bank account at any time by instructing the AMC to do so. In case of NRI investments, if the payment for the investment was made through an NRO account, then the registered account should also be of the same type. If payment was routed through an NRE account then the registered accounts can be an NRO or NRE account.

7.6.8 Cut-off Time

As seen earlier, the sale and re-purchase prices are a function of the applicable NAV. In order to ensure fairness to investors, SEBI has prescribed cut-off timing to determine the applicable NAV.

The provisions, which are uniformly applicable for all mutual funds, are as follows:

Type of Scheme	Transaction	Cut off time	Applicable NAV
Equity oriented funds and debt funds (except liquid funds) in respect	Purchases and Switch ins	3.00 pm	Same day NAV if received before cut off time.

of purchases less than Rs. 2 lakhs			Next business day NAV for applications received after cut off time.
Liquid fund	Purchases and Switch ins	2.00 pm	Previous day NAV if received before cut off time and funds are realised without availing any credit facility.
			If received after cut off time, NAV of the day previous to funds realisation.
Equity Oriented Funds, Debt funds (Other than Liquid funds)	Redemptions and Switch outs	3.00pm	Same day NAV if received before cut off time.
			Next business day NAV for applications received after cut off time.
Liquid funds	Redemptions and Switch outs	3.00pm	NAV of day immediately preceding the next business day, if received before cut off time.
			Next business day NAV for applications received after cut off time.
Equity oriented funds and debt funds (except liquid funds) in respect of transaction equal to or more than Rs. 2 lakhs	Purchases and Switch ins	3.00 pm	Irrespective of the time of receipt of application, NAV of the business day on which the funds are available for utilisation without availing of any credit facility before the cut-off time of that day is applicable.

The applicable NAV for switch-in transactions to liquid funds is the NAV of the day preceding the day of application provided

- The application is received before cut-off time
- Funds credited to the scheme's account before cut-off time
- Funds available for utilization without using any credit facilities

The above cut-off timing is not applicable for NFOs and International Schemes.

7.6.9 Time Stamping

The precision in setting cut-off timing make sense only if there is a fool proof mechanism of capturing the time at which the sale and re-purchase applications are received. This is ensured through the following:

Mutual funds disclose Official Points of Acceptance (OPoAs) and their addresses in the SID and their website. All transaction requests need to be submitted at the OPOAs. The time stamping on the transaction requests is done at the official points of acceptance.

As a convenience, the distributor may accept the transaction request from the investor, but this would need to be sent to an OPoA at the earliest. When the cut-off timing is applied, the time when it is submitted to the OPoA is relevant – not the time when the investor submits the transaction request to the distributor.

These points of acceptance have time stamping machines with tamper-proof seal. Opening the machine for repairs or maintenance is permitted only by vendors or nominated persons of the mutual fund. Such opening of the machine has to be properly documented and reported to the Trustees.

Applications are sequentially numbered from the first number of the machine to the last number of the machine, before a new numbering cycle is started for the machine. The daily time stamping of application does not start with serial 1.

Application for purchase of units is stamped with automatically generated location code, machine identifier, serial number, date and time; the reverse of the payment instrument has to be similarly stamped with the same number; the acknowledgement issued to the investor gets a similar stamp.

Application for re-purchase and investor's acknowledgement are stamped with the same information.

Similarly applications for non-financial transactions like change of address, and investor's acknowledgement are stamped. However, here stamping of time is not relevant; the data stamping is pertinent.

For online transactions, the time as per the web server to which the instruction goes, is used in determining the NAV for sale / re-purchase transactions.

7.7 Transactions through the Stock Exchange

Both National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) have extended their trading platform to help the stock exchange brokers become a channel for investors to transact in Mutual Fund Units. NSE's platform is called NEAT MFSS. BSE's platform is BSE StAR Mutual Funds Platform.

Both platforms are open from 9 am to 3 pm on every working day. Fresh subscriptions in a mutual fund, as well as additional purchases are possible. Similarly, redemptions are permitted. Each of these transactions may be in physical form or demat form.

Redemption requests can be given in number of units. Transactions are otherwise entered in the system based on proposed value of purchase or redemption.

The transaction slip generated by the broking system, also includes the time stamp. This serves the purpose of an acknowledgement for the investor.

The stock exchanges, together with their clearing corporation, handle the first leg of the transaction, viz. investor's subscription or re-purchase request. If these are in physical form, the stock exchange broker would need to arrange to send the documents to the nearest RTA.

The payment for purchase transactions have to be credited to the member's account before the order is placed. The stock exchange would provide the details of the orders to the mutual fund and to the depository for validation and on receiving the same the member's settlement account is debited and the funds transferred to the concerned mutual fund. The mutual fund would then process the order and credit the units to the investor's demat account by T+1 end of day. In case the investor wants physical units, all the documents, such as application form, PAN cards and KYC acknowledgement of all the holders, are sent to the mutual fund for validation on the same day itself. After validation, the member's account is debited and the funds are transferred to the mutual fund. The units are allotted and statement of account sent to the investor by the RTA. In case of redemption of units held in demat form once the order is placed and validated the investor has to direct the DP to transfer the units to the depository's pool account to be further transferred to the mutual fund's pool account. The mutual fund will credit the amount directly to the investor's bank account. In case of physical units, the redemption order is placed on the system by the member on receipt of the redemption request form. The same is sent to the mutual fund for processing.

The second leg of the transaction viz. sending units against investors' subscription, or sending money against the re-purchase request, is the responsibility of the RTA. Thus, stock exchanges only offer a transaction platform, but they do not replace the RTAs.

Since this is essentially an order routing system between the investors and the AMC, the exchanges do not offer Settlement Guarantee. Responsibility for settlement is that of the AMC. However, the normal stock exchange redressal mechanism would be available to address any investor complaints.

7.8 Investment Plans and Services

7.8.1 Dividend Payout, Growth and Dividend Re-Investment Options

Most mutual fund schemes offer two options – Dividend and Growth. A third option, which is possible, is the Dividend re-investment Option. These are different options within a scheme; they share the same portfolio. Therefore the portfolio returns are the same for all three options. However, they differ in the structure of cash flows and income accruals for the unit-holder, and therefore, the Unit-holder's taxability, number of units held and value of those units.

In a dividend payout option, the fund declares a dividend from time to time. Some schemes (liquid and debt funds with very short term maturity) even declare a dividend daily, subject to availability of profits.

As was seen in Chapter 6:

- When a dividend is paid, the NAV of the units falls to that extent.
- Debt schemes need to pay an income distribution tax on the dividend distributed. This tax payment too reduces the NAV.

The reduced NAV, after a dividend payout is called ex-Dividend NAV. After a dividend is announced, and until it is paid out, it is referred to as cum-Dividend NAV.

In a dividend payout option, the investor receives the dividend in his bank account; the NAV goes down to reflect the impact of the dividend paid, and, if applicable, the income distribution tax. However, the dividend payout does not change the number of units held by the investor.

The dividend received in the hands of the investor does not bear any tax, as per the current tax laws.

In a dividend re-investment option, as in the case of dividend payout option, NAV declines to the extent of dividend and income distribution tax. The resulting NAV is called ex-dividend NAV.

However, the investor does not receive the dividend in his bank account; the amount is re-invested in the same scheme and additional units are allotted to the investor. Thus, if dividend is Rs 2 per unit on a Unit-holder's 100 units, the dividend would amount to Rs 200. Assuming the ex-dividend NAV of the scheme is Rs 20, Rs 200 ÷ Rs 20 i.e. 10 units will be added to the unit-holder's portfolio.

Dividend is not declared in a growth option. Therefore, nothing is received in the bank account (unlike dividend payout option) and there is nothing to re-invest (unlike dividend re-investment option). In the absence of dividend, there is no question of income distribution tax. The NAV would therefore capture the full value of portfolio gains.

As in the case of dividend payout option, there will be no accretion to the number of units held; the NAV of those Units will however be higher, to reflect the gain in the portfolio.

Across the 3 options, the investor can also receive money by offering his units for re-purchase or selling them in the stock market. Taxability would depend on the scheme type and period of holding, as was discussed in Chapter 6.

In summary, the implication of the 3 options, is as follows:

Parameter	Dividend Payout Option	Dividend Re-investment Option	Growth Option
Dividend received in bank account	Yes	No	No
Income Distribution Tax	Yes, for non-equity schemes	Yes, for non-equity schemes	N.A.
Increase in number of units on account of re-investment of dividend	No	Yes	No
NAV change	NAV declines to the extent of dividend and income distribution tax	NAV declines to the extent of dividend and income distribution tax	NAV captures the portfolio change entirely

7.8.2 Systematic Investment Plan (SIP)

It is considered a good practice to invest regularly, particularly in to volatile markets such as equity markets. SIP is an approach where the investor invests constant amounts at regular intervals. A benefit of such an approach, particularly in equity schemes, is that it averages the unit-holder's cost of acquisition since more units are bought for the same amount of investment when the price/markets are down and fewer units when the price/markets are high.

Suppose an investor were to invest Rs 1,000 per month for 6 months. If, in the first month, the NAV is Rs10, the investor will be allotted Rs 1,000 ÷ Rs 10 i.e. 100 units. In the second month, if the NAV has gone up to Rs 12, the allotment of units will go down to Rs 1,000 ÷ Rs 12 i.e. 83.333 units. If the NAV goes down to Rs 9 in the following month, the unit-holder will be allotted a higher number of Rs 1,000 ÷ Rs 9 i.e. 111.111 units.

Thus, the investor acquires his Units at lower than the average of the NAV on the 6 transaction dates during the 6 month period – a reason why this approach is also called *Rupee Cost Averaging*. Systematic investing allows investors buy into a volatile market over time at an average price without having to predict market movements. Mutual funds make it convenient for investors to lock into SIPs by investing through Post-Dated Cheques (PDCs), ECS or standing instructions.

7.8.3 Systematic Withdrawal Plan (SWP)

Just as investors do not want to buy all their units at a market peak, they do not want to risk redeeming all their units in a market trough. Investors can therefore opt for the safer route of offering for re-purchase, a constant value of units over a period of time.

Suppose an investor were to offer for re-purchase Rs 1,000 per month for 6 months. If, in the first month, the NAV is Rs 10, the investor's unit-holding will be reduced by Rs 1,000 ÷ Rs 10 i.e. 100 units. In the second month, if the NAV has gone up to Rs 12, the unit-holding will go down by fewer units viz. Rs 1,000 ÷ Rs 12 i.e. 83.333 units. If the NAV goes down to Rs 9 in the following month, the unit-holder will be offering for re-purchase a higher number of units viz. Rs 1,000 ÷ Rs 9 i.e. 111.111 units. Thus, the investor re-purchases his Units at an average NAV during the 6 month period. The investor does not end up in the unfortunate position of exiting all the units in a market trough.

Mutual funds make it convenient for investors to manage their SWPs by indicating the amount, periodicity (generally, monthly) and period for their SWP. Some schemes even offer the facility of transferring only the appreciation or the dividend. Accordingly, the mutual fund will re-purchase the appropriate number of units of the unit-holder, without the formality of having to give a re-purchase instruction for each transaction.

An investor may opt for SWP for several reasons:

- As discussed earlier, minimise the risk of redeeming all the units during a market trough.
- Meet liquidity needs for regular expenses.
- Assuming the scheme is profitable, the re-purchase ensures that some of the profits are being regularly encashed by the investor.
- As discussed under Taxation, debt schemes are subject to Income Distribution Tax. In such schemes, it would be more tax-efficient to take money out of the scheme as a re-purchase

(on which there is no income distribution tax) as compared to dividend (which would be liable to income distribution tax) if the rate of tax on the capital gains, if any, is lower than the dividend distribution tax.

7.8.4 Systematic Transfer Plan (STP)

This is a variation of SWP. While in a SWP the constant amount is paid to the investor at the pre-specified frequency, in a STP, the amount that is withdrawn from a scheme is re-invested in some other scheme of the same mutual fund. Thus, it operates as a SWP from the first scheme, and a SIP into the second scheme. Since the investor is effectively switching between schemes, it is also called "switch". If the unit-holder were to do this SWP and SIP as separate transactions-

- The Unit-holder ends up waiting for funds during the time period that it takes to receive the re-purchase proceeds, and has idle funds, during the time it takes to re-invest in the second scheme. During this period, the market movements can be adverse for the unit-holder.
- The Unit-holder has do two sets of paper work (Sale and Re-purchase) for every period.

The STP offered by mutual funds is a cost-effective and convenient facility. It can be used by investors to make periodic investments into a volatile market such as equity, or to rebalance a portfolio, or to book profits. Investors can choose to transfer a fixed amount each period or to transfer the appreciation in a scheme.

A switch is a redemption from one scheme and a purchase into another combined into one transaction. For example, investors who believe that equity markets have peaked and want to book profits can switch out from an equity scheme and switch into a short-term debt fund.

7.8.5 Operational aspects of Systematic Transactions

Mutual funds specify the schemes in which systematic transactions are offered. The fund will also specify the minimum investment for each tranche, the dates on which the transactions can be conducted and the minimum period for which the investor can sign up. From the available options the investor can choose the amount of the periodic transaction, the frequency (monthly, quarterly, semi-annual, annual), the period over which the transaction will be done and the dates. In case of systematic transfers and switches, the source and target schemes have to be selected. The enrollment form has to be submitted to the mutual fund a specified number of days before the first installment, typically 15 to 30 days. The payment modes accepted for SIPs include post-dated cheques and electronic payment modes such as ECS, direct debit and standing instructions (SI). The cheque numbers, date and amount for each cheque has to be provided. An authorization to the bank to execute the electronic payment has to be signed which will be registered with the bank by the mutual fund. In case of systematic withdrawals, the credits will be made to the default bank account, or any other account as required by the investor and registered with the mutual fund. The mutual fund may specify the minimum amounts for each tranche of a systematic transaction.

Each tranche of a systematic transaction will be executed at the applicable NAV on the date of the transaction. In case of transfers, each leg of the transfer (redemption and purchase) will be executed at the applicable NAV for each scheme. The investor will have to bear the loads and taxes as applicable. A systematic transaction can be cancelled at any time by giving the mutual fund notice in writing.

7.8.6 Triggers

It is not uncommon for investors to rue missed opportunities of buying or selling because they could not give the requisite instructions in time. This is addressed through the trigger option that is available for some schemes.

For instance, an investor can specify that the Units would be re-purchased if the market reaches a particular level. In that case, once the market reaches that level, the Units would be re-purchased, without the need for going through a separate re-purchase documentation. It stands to reason that if the market continues to go up after the trigger is auctioned, the investor loses on the further gain.

Similarly, an investor can set a trigger to transfer moneys into an equity scheme when the market goes down, say 20%. This would help the investor conveniently increase his position in equities, when the market goes down 20%.

Triggers can be used in conjunction with switch or STP to manage the investments. Investors should study the conditions attached to trigger options (and any value added service), because these vary from scheme to scheme.

7.8.7 Statement of Account and Investment Certificate

The time limit within which these need to be issued was discussed in Chapter3. The Statement of Account shows for each transaction (sale / re-purchase), the value of the transaction, the relevant NAV and the number of units transacted. Besides, it also provides the closing balance of units held in that folio, and the value of those units based on the latest NAV.

Annual Account Statement:

The Mutual Funds shall provide the Account Statement to the Unit-holders who have not transacted during the last six months prior to the date of generation of account statements. The Account Statement shall reflect the latest closing balance and value of the Units prior to the date of generation of the account statement.

The account statements in such cases may be generated and issued along with the Portfolio Statement or Annual Report of the Scheme.

Alternately, soft copy of the account statements shall be mailed to the investors' e-mail address, instead of physical statement, if so mandated.

Consolidated Account Statement (CAS):

A Consolidated Account Statement (CAS) for each calendar month will be sent by post/email on or before 10th of the succeeding month.

If an email id is registered with the AMC, only a CAS via email will be sent. For the purpose of sending CAS, investors will be identified across mutual funds by their Permanent Account Number (PAN). Where PAN is not available, the account statement shall be sent to the Unit holder.

Further, where there are no transactions in a folio during any six month period, a CAS detailing holding across all schemes of all mutual funds at the end of every such six month period (i.e. September/March), shall be sent by post/e-mail by the 10th day of the month following that half year, to all such Unit holders.

7.8.8 Nomination

Most investors like clarity about what would happen to their unit-holding, in the unfortunate event of their demise. This clarity can be achieved by executing a Nomination Form, where the nominee's name is specified. In the case of joint holding, every unit-holder will have to sign the nomination form. Nomination is optional and can be made at any time. It can also be cancelled or changed. Only individual investors can make a nomination. Investments by minors cannot have a nomination. The nominee can be individual, including minors and NRIs.

If the nominee is a minor, then a guardian too can be specified. A religious or charitable trust can also be a nominee.

If one joint holder dies, then the Units will continue to be held by the surviving joint holder/s. If the sole Unit-holder or all joint holders die/s, then the Units will be transferred to the nominee. Before the transfer is effected, the mutual fund will insist on the KYC documentation from the nominee, death certificate/s of the deceased, and an indemnity against future problems for the mutual fund arising out of the transfer.

It would be pertinent to note here that nomination is only an authorization for the mutual fund to transfer the units to the nominee in the event of demise of the unit-holder. The nominee will hold the units in trust for the legal heirs of the investor. The inheritance laws applicable to the unit-holder too need to be considered by the investor if they are looking at nomination as a way of passing on their wealth to their heirs. Professional advice on inheritance issues and preparation of a Will are strongly advised.

7.8.9 Pledge

Banks, NBFCs and other financiers often lend money against pledge of Units by the Unit-holder. This is effected through a *Pledge Form* executed by the unit-holder/s (*pledger/s*). The form has a provision for specifying the party in whose favour the Units are pledged (*pledgee*).

Once Units are pledged, the Unit-holder/s cannot sell or transfer the pledged units, until the pledgee gives a no-objection to release the pledge.

7.8.10 Change in Folio Details

The personal information of the investor captured under the folio is liable to changes which have to be updated in the records. Some of the information, such as name, address, status and contact details, are provided during the KYC compliance process. Any changes have to be updated with the KRA using the change form. The KRA will communicate the updated information to all the mutual funds. Any change in bank accounts have to be registered with each mutual fund. Change in the mode of holding an operating a folio, or the nominations made in an investment, have to be updated with each mutual fund.

A change in guardian in a minor’s folio will require the new guardian to comply with KYC and PAN requirements, provide bank account details and a no-objection from the existing guardian. The change in the status of an investor from minor to major will require the PAN and KYC compliance of the investor to replace that of the guardian. The signature of the investor and the bank account details has to be updated in the records. The guardian will cease operating the account.

Transmission is the process of transferring units to the person entitled to receive it in the event of the death of the unit holder. The person entitled to receive it depends upon the folio conditions of joint holding and nomination. If the first holder passes away, the second holder is substituted as first holder. In a singly held folio with nominations, the units are transferred to the nominee. If a folio is jointly held and has nominations, the right of the joint holder will take precedence. If there are no nominations in the folio, the units are transmitted to the legal successors.

A request for transmission has to be made in the format prescribed by the mutual fund. It must include the documents to establish death and claim. This includes the attested copy of death certificate, probate of will, succession certificate, No objection certificate from the legal heirs. Once the transmission is done the new holder must comply with KYC and PAN details and register the bank account with the mutual fund.

A request for transmission has to made in the format prescribed by the mutual fund and must include the documents necessary to establish death and claim. This includes the attested copy of death certificate, probate of will, succession certificate, No Objection certificate and Indemnity bond from legal heirs, if necessary. Once the units are transmitted, the new first holder must comply with KYC and PAN requirements and register their bank account details with the fund.

7.8.11 Investor Services

SEBI's guidelines prescribe the turnaround times for investors' transactions with the mutual fund.

- Allotment of units in the NFO must be completed within 5 days from closing of NFO. In case of ELSS, the allotment must be done within 30 days and within 15 days for units under the RGESS
- Dividend warrants should be despatched within 30 days of the declaration
- Redemption proceeds have to be despatched within 10 working days of the repurchase
- An SoA reflecting the transaction request has to be sent to the investor within 5 working days of the transaction request.

AMCs (and also some distributors) offer various other services for investors. Some of these are as follows:

- Online access to information on investments, including consolidated view of various folios that relate to different family members.
- Daily NAV and other key developments transmitted through SMS / E-mail.
- Sharing of information on portfolio valuation, income booked, returns earned, capital gains working for income tax purposes etc.

7.9 Appendix 5: KYC Form for Individuals

Know Your Client (KYC)
Application Form (For Individuals Only)

Please fill in ENGLISH and in BLOCK LETTERS

CVL

Place for Intermediary Logo

Application No. :

A. Identity Details (please see guidelines overleaf)

1. Name of Applicant (As appearing in supporting identification document)
Name

PHOTOGRAPH

Please affix the recent passport size photograph and sign across it

Father's/Spouse Name

2. Gender ☐ Male ☐ Female B. Marital status ☐ Single ☐ Married C. Date of Birth d d / m m / y y y y

3. Nationality ☐ Indian ☐ Other (Please specify)

4. Status Please tick (✓) ☐ Resident Individual ☐ Non Resident ☐ Foreign National (Passport Copy Mandatory for NRIs & Foreign Nationals)

5. PAN Please enclose a duly attested copy of your PAN Card

Aadhaar Number, if any:

6. Proof of Identity submitted for PAN exempt cases Please Tick (✓)
☐ UID (Aadhaar) ☐ Passport ☐ Voter ID ☐ Driving Licence ☐ Others (Please see guideline 'D' overleaf

B. Address Details (please see guidelines overleaf)

1. Address for Correspondence

City / Town / Village Pin Code
State Country

2. Contact Details
Tel. (Off.) (ISD) (STD) Tel. (Res.) (ISD) (STD)
Mobile (ISD) (STD) Fax (ISD) (STD)
E-Mail Id.

3. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents & tick (✓) against the document attached.
☐ Passport ☐ Ration Card ☐ Registered Lease/Sale Agreement of Residence ☐ Driving License ☐ Voter Identity Card ☐ *Latest Bank A/c Statement/Passbook
☐ *Latest Telephone Bill (only Land Line) ☐ *Latest Electricity Bill ☐ *Latest Gas Bill ☐ Others (Please specify)
*Not more than 3 Months old. Validity/Expiry date of proof of address submitted d d / m m / y y y y

4. Permanent Address of Resident Applicant if different from above B1 OR Overseas Address (Mandatory) for Non-Resident Applicant

City / Town / Village Pin Code
State Country

5. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents & tick (✓) against the document attached.
☐ Passport ☐ Ration Card ☐ Registered Lease/Sale Agreement of Residence ☐ Driving License ☐ Voter Identity Card ☐ *Latest Bank A/c Statement/Passbook
☐ *Latest Telephone Bill (only Land Line) ☐ *Latest Electricity Bill ☐ *Latest Gas Bill ☐ Others (Please specify)
*Not more than 3 Months old. Validity/Expiry date of proof of address submitted d d / m m / y y y y

6. Any other information:

DECLARATION

I hereby declare that the details furnished above are true and correct to the best of my/our knowledge and belief and I undertake to inform you of any changes therein, immediately. In case any of the above information is found to be false or untrue or misleading or misrepresenting, I am/we are aware that I/we may be held liable for it.

Place: Date:

SIGNATURE OF APPLICANT

FOR OFFICE USE ONLY

IPV Done ☐ on d d / m m / y y y y

AMC/Intermediary name OR code

☐ (Originals Verified) Self Certified Document copies received

☐ (Attested) True copies of documents received

Main Intermediary

Seal/Stamp of the intermediary should contain
Staff Name
Designation
Name of the Organization
Signature
Date

Seal/Stamp of the intermediary should contain
Staff Name
Designation
Name of the Organization
Signature
Date

INSTRUCTIONS / CHECK LIST FOR FILLING KYC FORM

A. IMPORTANT POINTS:

1. Self attested copy of PAN card is mandatory for all clients.
2. Copies of all the documents submitted by the applicant should be self-attested and accompanied by originals for verification. In case the original of any document is not produced for verification, then the copies should be properly attested by entities authorized for attesting the documents, as per the below mentioned list.
3. If any proof of identity or address is in a foreign language, then translation into English is required.
4. Name & address of the applicant mentioned on the KYC form, should match with the documentary proof submitted.
5. If correspondence & permanent address are different, then proofs for both have to be submitted.
6. Sole proprietor must make the application in his individual name & capacity.
7. For non-residents and foreign nationals,(allowed to trade subject to RBI and FEMA guidelines), copy of passport/PIO Card/OCI Card and overseas address proof is mandatory.
8. For foreign entities, CIN is optional; and in the absence of DIN no. for the directors, their passport copy should be given.
9. In case of Merchant Navy NRI's, Mariner's declaration or certified copy of CDC (Continuous Discharge Certificate) is to be submitted.
10. For opening an account with Depository participant or Mutual Fund, for a minor, photocopy of the School Leaving Certificate/Mark sheet issued by Higher Secondary Board/Passport of Minor/Birth Certificate must be provided.
11. Politically Exposed Persons (PEP) are defined as individuals who are or have been entrusted with prominent public functions in a foreign country, e.g., Heads of States or of Governments, senior politicians, senior Government/judicial/military officers, senior executives of state owned corporations, important political party officials, etc.

B. Proof of Identity(POI): List of documents admissible as Proof of Identity:

1. PAN card with photograph. This is a mandatory requirement for all applicants except those who are specifically exempt from obtaining PAN (listed in Section D).
2. Unique Identification Number (UID) (Aadhaar) / Passport / Voter ID card / Driving license.
3. Identity card/ document with applicant's Photo, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities, Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc., to their Members; and Credit cards/Debit cards issued by Banks.

C. Proof of Address (POA): List of documents admissible as Proof of Address: (*Documents having an expiry date should be valid on the date of submission.)

1. Passport/Voters Identity Card/Ration Card/Registered Lease or Sale Agreement of Residence/Driving License/Flat Maintenance bill/Insurance Copy.
2. Utility bills like Telephone Bill (only land line), Electricity bill or Gas bill - Not more than 3 months old.
3. Bank Account Statement/Passbook - Not more than 3 months old.
4. Self-declaration by High Court and Supreme Court judges, giving the new address in respect of their own accounts.
5. Proof of address issued by any of the following: Bank Managers of Scheduled Commercial Banks/Scheduled Co-Operative Bank/Multinationa Foreign Banks/Gazetted Officer/Notary public/Elected representatives to the Legislative Assembly/Parliament/Documents issued by any Govt. or Statutory Authority.
6. Identity card/document with address, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities and Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc., to their Members.
7. For FII/sub account, Power of Attorney given by FII/sub-account to the Custodians (which are duly notarized and/or apostiled or consularised) that gives the registered address should be taken.
8. The proof of address in the name of the spouse may be accepted.

D. Exemptions/clarifications to PAN
(*Sufficient documentary evidence in support of such claims to be collected.)

1. In case of transactions undertaken on behalf of Central Government and/or State Government and by officials appointed by Courts e.g. Official liquidator, Court receiver etc.
2. Investors residing in the state of Sikkim.
3. UN entities/multilateral agencies exempt from paying taxes/filing tax returns in India.
4. SIP of Mutual Funds upto Rs 50,000/- p.a.
5. In case of institutional clients, namely, FIIs, Mfs, VCFs, FVCIs, Scheduled Commercial Banks, Multilateral and Bilateral Development Financial Institutions, State Industrial Development Corporations, Insurance Companies registered with IRDA and Public Financial Institution as defined under section 4A of the Companies Act, 1956, Custodians shall verify the PAN card details with the original PAN card and provide duly certified copies of such verified PAN details to the intermediary.

E. List of people authorized to attest the documents:

1. Notary Public, Gazetted Officer, Manager of a Scheduled Commercial/Co-operative Bank or Multinational Foreign Banks (Name, Designation & Seal should be affixed on the copy).
2. In case of NRIs, authorized officials of overseas branches of Scheduled Commercial Banks registered in India, Notary Public, Court Magistrate, Judge, Indian Embassy/Consulate General in the country where the client resides are permitted to attest the documents.

Please Submit the KYC Documents on A4 Size Paper Only.

7.10 Appendix 6: KYC Form for Non-individuals

N

Know Your Client (KYC)
Application Form (For Non-Individuals Only)

Please fill in ENGLISH and in BLOCK LETTERS

CVL

Place for Intermediary Logo

Application No. :

A. Identity Details (please see guidelines overleaf)

1. Name of Applicant (Please write complete name as per Certificate of Incorporation / Registration; leaving one box blank between 2 words. Please do not abbreviate the Name).

2. Date of Incorporation d d / m m / y y y y **Place of Incorporation**

3. Registration No. (e.g. CIN) **Date of commencement of business** d d / m m / y y y y

4. Status Please tick (✓) ☐ Private Ltd. Co. ☐ Public Ltd. Co. ☐ Body Corporate ☐ Partnership ☐ Trust / Charities / NGOs ☐ HUF ☐ FI ☐ FII ☐ FPI Category I ☐ FPI Category II ☐ FPI Category III ☐ AOP ☐ Bank ☐ Government Body ☐ Non-Government Organisation ☐ Defence Establishment ☐ Body of Individuals ☐ Society ☐ LLP ☐ Others (Please specify)

5. Permanent Account Number (PAN) (MANDATORY) Please enclose a duly attested copy of your PAN Card

B. Address Details (please see guidelines overleaf)

1. Address for Correspondence

City / Town / Village Postal Code
State Country

2. Contact Details

Tel. (Off.) (ISD) (STD) Tel. (Res.) (ISD) (STD)
Mobile (ISD) (STD) Fax (ISD) (STD)
E-Mail Id.

3. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents & tick (✓) against the document attached.
☐ *Latest Telephone Bill (only Land Line) ☐ *Latest Electricity Bill ☐ *Latest Bank Account Statement ☐ Registered Lease / Sale Agreement of Office Premises
☐ Any other proof of address document (as listed overleaf).(Please specify)
*Not more than 3 Months old. **Validity/Expiry date of proof of address submitted** d d / m m / y y y y

4. Registered Address (If different from above)

City / Town / Village Postal Code
State Country

5. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents & tick (✓) against the document attached.
☐ *Latest Telephone Bill (only Land Line) ☐ *Latest Electricity Bill ☐ *Latest Bank Account Statement ☐ Registered Lease / Sale Agreement of Office Premises
☐ Any other proof of address document (as listed overleaf).(Please specify)
*Not more than 3 Months old. **Validity/Expiry date of proof of address submitted** d d / m m / y y y y

C. Other Details (please see guidelines overleaf)

1. Name, PAN, DIN/Aadhaar Number, residential address and photographs of Promoters/Partners/Karta/Trustees/whole time directors (Please use the Annexure to fill in the details)

2. Any other information:

DECLARATION

I/We hereby declare that the details furnished above are true and correct to the best of my/our knowledge and belief and I/We undertake to inform you of any changes therein, immediately. In case any of the above information is found to be false or untrue or misleading or misrepresenting, I am/we are aware that I/We may be held liable for it.

Place:

Date:

NAME & SIGNATURE(S) OF AUTHORISED PERSON(S)

FOR OFFICE USE ONLY

AMC/Intermediary name **OR** code

☐ (Originals Verified) Self Certified Document copies received

☐ (Attested) True copies of documents received

Seal/Stamp of the intermediary should contain
Staff Name
Designation
Name of the Organization
Signature
Date

N

INSTRUCTIONS / CHECK LIST FOR FILLING KYC FORM

A. IMPORTANT POINTS:

1. Self attested copy of PAN card is mandatory for all clients.
2. Copies of all the documents submitted by the applicant should be self-attested and accompanied by originals for verification. In case the original of any document is not produced for verification, then the copies should be properly attested by entities authorized for attesting the documents, as per the below mentioned list.
3. If any proof of identity or address is in a foreign language, then translation into English is required.
4. Name & address of the applicant mentioned on the KYC form, should match with the documentary proof submitted.
5. If correspondence & permanent address are different, then proofs for both have to be submitted.
6. Sole proprietor must make the application in his individual name & capacity.
7. For non-residents and foreign nationals,(allowed to trade subject to RBI and FEMA guidelines), copy of passport/PIOCard/OCICard and overseas address proof is mandatory.
8. For foreign entities, CIN is optional; and in the absence of DIN no. for the directors, their passport copy should be given.
9. In case of Merchant Navy NRI's, Mariner's declaration or certified copy of CDC (Continuous Discharge Certificate) is to be submitted.
10. For opening an account with Depository participant or Mutual Fund, for amin or, photocopy of the School Leaving Certificate/Mark sheet issued by Higher Secondary Board/Passport of Minor/Birth Certificate must be provided.
11. Politically Exposed Persons (PEP) are defined as individuals who are or have been entrusted with prominent public functions in a foreign country, e.g., Heads of States or of Governments, senior politicians, senior Government/judicial/military officers, senior executives of state owned corporations, important political party officials, etc.

B. Proof of Identity(POI): List of documents admissible as Proof of Identity:

1. PAN card with photograph. This is a mandatory requirement for all applicants except those who are specifically exempt from obtaining PAN (listed in Section D).
2. Unique Identification Number (UID) (Aadhaar)/Passport/Voter ID card/Driving license.
3. Identity card/ document with applicant's Photo, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities, Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc., to their Members; and Credit cards/Debit cards issued by Banks.

C. Proof of Address (POA): List of documents admissible as Proof of Address: (*Documents having an expiry date should be valid on the date of submission.)

1. Passport/Voters Identity Card/Ration Card/Registered Lease or Sale Agreement of Residence/Driving License/Flat Maintenance bill/Insurance Copy.
2. Utility bills like Telephone Bill (only land line), Electricity bill or Gas bill - Not more than 3 months old.
3. Bank Account Statement/Passbook - Not more than 3 months old.
4. Self-declaration by High Court and Supreme Court judges, giving the new address in respect of their own accounts.
5. Proof of address issued by any of the following: Bank Managers of Scheduled Commercial Banks/Scheduled Co-Operative Bank/Multinational Foreign Banks/Gazetted Officer/Notary public/Elected representatives to the Legislative Assembly/Parliament/Documents issued by any Govt. or Statutory Authority.
6. Identity card/document with address, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions,Colleges affiliated to Universities and Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc.,to their Members.
7. For FII/sub account, Power of Attorney given by FII/sub-account to the Custodians (which are duly notarized and/or apostiled or consularised) that gives the registered address should be taken.
8. The proof of address in the name of the spouse may be accepted.

D. Exemptions/clarifications to PAN

(*Sufficient documentary evidence in support of such claims to be collected.)

1. In case of transactions undertaken on behalf of Central Government and/or State Governmentand by officials appointed by Courts e.g. Official liquidator, Court receiver etc.
2. Investors residing in the state of Sikkim.
3. UN entities/multilateral agencies exempt from paying taxes/filing tax returns in India.
4. SIP of Mutual Funds upto Rs 50,000/- p.a.
5. In case of institutional clients, namely, FIIs, Mfs, VCFs, FVCIs, Scheduled Commercial Banks, Multilateral and Bilateral Development Financial Institutions, State Industrial Development Corporations, Insurance Companies registered with IRDA and Public Financial Institution as defined under section 4A of the Companies Act, 1956, Custodians shall verify the PAN card details with the original PAN card and provide duly certified copies of such verified PAN details to the intermediary.

E. List of people authorized to attest the documents:

1. Notary Public, Gazetted Officer, Manager of a Scheduled Commercial/Co-operative Bank or Multinational Foreign Banks (Name, Designation & Seal should be affixed on the copy).
2. In case of NRIs, authorized officials of overseas branches of Scheduled Commercial Banks registered in India, Notary Public, Court Magistrate, Judge, Indian Embassy/Consulate General in the country where the client resides are permitted to attest the documents.

F. In case of Non-Individuals, additional documents to be obtained from Non-individuals, over & above the POI & POA, as mentioned below:

Types of entity	Documentary requirements
Corporate	• Copy of the balance sheets for the last 2 financial years (to be submitted every year) • Copy of latest share holding pattern including list of all those holding control, either directly or indirectly, in the company in terms of SEBI takeover Regulations, duly certified by the company secretary/Whole time director/MD(to be submitted every year) • Photograph, POI, POA, PAN and DIN numbers of whole time directors/two directors in charge of day to day operations • Photograph, POI, POA, PAN of individual promoters holding control – either directly or indirectly • Copies of the Memorandum and Articles of Association and certificate of incorporation • Copy of the Board Resolution for investment in securities market • Authorised signatories list with specimen signatures
Partnership firm	• Copy of the balance sheets for the last 2 financial years (to be submitted every year) • Certificate of registration (for registered partnership firms only) • Copy of partnership deed • Authorised signatories list with specimen signatures • Photograph, POI, POA, PAN of Partners
Trust	• Copy of the balance sheets for the last 2 financial years (to be submitted every year) • Certificate of registration (for registered trust only).Copy of Trust deed • List of trustees certified by managing trustees/CA • Photograph, POI, POA, PAN of Trustees
HUF	• PAN of HUF • Deed of declaration of HUF/List of coparceners • Bank pass-book/bank statement in the name of HUF • Photograph, POI, POA, PAN of Karta
Unincorporated Association or a body of individuals	• Proof of Existence/Constitution document • Resolution of the managing body & Power of Attorney granted to transact business on its behalf • Authorized signatories list with specimen signatures
Banks/Institutional Investors	• Copy of the constitution/registration or annual report/balance sheet for the last 2 financial years • Authorized signatories list with specimen signatures
Foreign Institutional Investors (FII)	• Copy of SEBI registration certificate • Authorized signatories list with specimen signatures
Army/Government Bodies	• Self-certification on letterhead • Authorized signatories list with specimen signatures
Registered Society	• Copy of Registration Certificate under Societies Registration Act • List of Managing Committee members • Committee resolution for persons authorised to act as authorised signatories with specimen signatures • True copy of Society Rules and Bye Laws certified by the Chairman/Secretary

Please Submit the KYC Documents on A4 Size Paper Only.

Details of Promoters/ Partners/ Karta / Trustees and whole time directors forming a part of Know Your Client (KYC) Application Form for Non-Individuals

Name of Applicant ____________________ PAN of the Applicant

Sr. No.	PAN	Name	DIN (For Directors) / Aadhaar Number (For Others)	Residential / Registered Address	Relationship with Applicant (i.e. promoters, whole time directors etc.)	Photograph

Name & Signature of the Authorised Signatory(ies) Date d d / m m / y y y y

CVL

Place for Intermediary Logo

7.11 Appendix 7: KYC Change Form for Individuals

CI

KYC Details Change form (For Individuals Only)

CVL

Place for Intermediary Logo

Application No. :

Please fill this update / modification form in ENGLISH and in BLOCK LETTERS (Please strike off Sections that are not used).

A Name of Applicant (Mandatory as per original KYC records)

Title ☐ Mr. ☐ Ms. ☐ Other (Please specify) Aadhaar Number, if any: PAN

Name

Date of Birth d d / m m / y y y y

Please Provide the new KYC details which should be updated in your KYC records.

B. Mandatory fields for KYCs done before 1st January 2012

1. Father's/Spouse Name

2. Current Marital status ☐ Single ☐ Married 3. Current Nationality ☐ Indian ☐ Other (Please specify)

Note **"FOR OFFICE USE ONLY":** The IPV Column should be mandatorily filled for all KYCs registered before 1st January 2012. Originals Seen and Verified should be mandatorily filled for changes to Identity and Address details.

C. Identity Details (please see guidelines overleaf)

1. New Name (As appearing in supporting identification document).

Name

2. New Status Please tick (✓) ☐ Resident Individual ☐ Non Resident (Passport Copy Mandatory for NRIs & Foreign Nationals)

3. PAN Please enclose a duly attested copy of your PAN Card

4. Proof of Identity submitted for PAN exempt cases Please Tick (✓)

☐ Aadhaar Card ☐ Passport ☐ Voter ID ☐ Driving Licence ☐ Others (Please see guideline 'D' overleaf)

D. Address Details (please see guidelines overleaf)

1. New Address for Correspondence

City / Town / Village Pin Code

State Country

2. Contact Details

Tel. (Off.) (ISD) (STD) Tel. (Res.) (ISD) (STD)

Mobile (ISD) (STD) Fax (ISD) (STD)

E-Mail Id.

3. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents & tick (✓) against the document attached.

☐ Passport ☐ Ration Card ☐ Registered Lease/Sale Agreement of Residence ☐ Driving License ☐ Voter Identity Card ☐ *Latest Bank A/c Statement/Passbook ☐ *Latest Telephone Bill (only Land Line) ☐ *Latest Electricity Bill ☐ *Latest Gas Bill ☐ Others (Please specify)

*Not more than 3 Months old. Validity/Expiry date of proof of address submitted d d / m m / y y y y

4. New Permanent Address of Resident Applicant if different from above C1 OR Overseas Address (Mandatory) for Non-Resident Applicant

City / Town / Village Pin Code

State Country

5. Proof of address to be provided by Applicant. Please submit ANY ONE of the following valid documents & tick (✓) against the document attached.

☐ Passport ☐ Ration Card ☐ Registered Lease/Sale Agreement of Residence ☐ Driving License ☐ Voter Identity Card ☐ *Latest Bank A/c Statement/Passbook ☐ *Latest Telephone Bill (only Land Line) ☐ *Latest Electricity Bill ☐ *Latest Gas Bill ☐ Others (Please specify)

*Not more than 3 Months old. Validity/Expiry date of proof of address submitted d d / m m / y y y y

6. Any other information:

SIGNATURE OF APPLICANT	DECLARATION	SIGNATURE OF APPLICANT
Old signature as per original KYC Wherever Applicable	I hereby declare that the details furnished above are true and correct to the best of my/our knowledge and belief and I undertake to inform you of any changes therein, immediately. In case any of the above information is found to be false or untrue or misleading or misrepresenting, I am/we are aware that I/we may be held liable for it. Place: Date: d d / m m / y y y y	

FOR OFFICE USE ONLY IPV Done ☐ on d d / m m / y y y y

AMC/Intermediary name OR code ☐ (Originals Verified) Self Certified Document copies received ☐ (Attested) True copies of documents received Main Intermediary	Seal/Stamp of the intermediary should contain Staff Name Designation Name of the Organization Signature Date	Seal/Stamp of the intermediary should contain Staff Name Designation Name of the Organization Signature Date

CI

INSTRUCTIONS / CHECK LIST FOR FILLING KYC FORM

A. IMPORTANT POINTS:

1. **Self attested copy of PAN card is mandatory for all clients in all type of change request.**
2. Copies of all the documents submitted by the applicant should be self-attested and accompanied by originals for verification. In case the original of any document is not produced for verification, then the copies should be properly attested by entities authorized for attesting the documents, as per the below mentioned list.
3. If any proof of identity or address is in a foreign language, then translation into English is required.
4. Name & address of the applicant mentioned on the KYC form, should match with the documentary proof submitted.
5. If correspondence & permanent address are different, then proofs for both have to be submitted.
6. Sole proprietor must make the application in his individual name & capacity.
7. For non-residents and foreign nationals,(allowed to trade subject to RBI and FEMA guidelines), copy of passport/PIOCard/OCICard and overseas address proof is mandatory.
8. For foreign entities, CIN is optional; and in the absence of DIN no. for the directors, their passport copy should be given.
9. In case of Merchant Navy NRI's, Mariner's declaration or certified copy of CDC (Continuous Discharge Certificate) is to be submitted.
10. For opening an account with Depository participant or Mutual Fund, for a minor, photocopy of the School Leaving Certificate/Mark sheet issued by Higher Secondary Board/Passport of Minor/Birth Certificate must be provided.
11. Politically Exposed Persons (PEP) are defined as individuals who are or have been entrusted with prominent public functions in a foreign country, e.g., Heads of States or of Governments, senior politicians, senior Government/judicial/military officers, senior executives of state owned corporations, important political party officials, etc.

B. Proof of Identity(POI): List of documents admissible as Proof of Identity:

1. PAN card with photograph. This is a mandatory requirement for all applicants except those who are specifically exempt from obtaining PAN (listed in Section D).
2. Aadhaar Number / Passport / Voter ID card / Driving license.
3. Identity card/ document with applicant's Photo, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities, Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc., to their Members; and Credit cards/Debit cards issued by Banks.

C. Proof of Address (POA): List of documents admissible as Proof of Address: (*Documents having an expiry date should be valid on the date of submission.)

1. Aadhaar Number / Passport / Voters Identity Card/Ration Card/Registered Lease or Sale Agreement of Residence/Driving License/Flat Maintenance bill/Insurance Copy.
2. Utility bills like Telephone Bill (only land line), Electricity bill or Gas bill Not more than 3 months old.
3. Bank Account Statement/Passbook - Not more than 3 months old.
4. Self-declaration by High Court and Supreme Court judges, giving the new address in respect of their own accounts.
5. Proof of address issued by any of the following: Bank Managers of Scheduled Commercial Banks/Scheduled Co-Operative Bank/Multinational Foreign Banks/Gazetted Officer/Notary public/Elected representatives to the Legislative Assembly/Parliament/Documents issued by any Govt. or Statutory Authority.
6. Identity card/document with address, issued by any of the following: Central/State Government and its Departments, Statutory/Regulatory Authorities, Public Sector Undertakings, Scheduled Commercial Banks, Public Financial Institutions, Colleges affiliated to Universities and Professional Bodies such as ICAI, ICWAI, ICSI, Bar Council etc., to their Members.
7. For FII/sub account, Power of Attorney given by FII/sub-account to the Custodians (which are duly notarized and/or apostiled or consularised) that gives the registered address should be taken.
8. The proof of address in the name of the spouse may be accepted.

D. Exemptions/clarifications to PAN
(*Sufficient documentary evidence in support of such claims to be collected.)

1. In case of transactions undertaken on behalf of Central Government and/or State Government and by officials appointed by Courts e.g. Official liquidator, Court receiver etc.
2. Investors residing in the state of Sikkim.
3. UN entities/multilateral agencies exempt from paying taxes/filing tax returns in India.
4. SIP of Mutual Funds upto Rs 50,000/- p.a.
5. In case of institutional clients, namely, FIIs, Mfs, VCFs, FVCIs, Scheduled Commercial Banks, Multilateral and Bilateral Development Financial Institutions, State Industrial Development Corporations, Insurance Companies registered with IRDA and Public Financial Institution as defined under section 4A of the Companies Act, 1956, Custodians shall verify the PAN card details with the original PAN card and provide duly certified copies of such verified PAN details to the intermediary.

E. List of people authorized to attest the documents:

1. Notary Public, Gazetted Officer, Manager of a Scheduled Commercial/Co-operative Bank or Multinational Foreign Banks (Name, Designation & Seal should be affixed on the copy).
2. In case of NRIs, authorized officials of overseas branches of Scheduled Commercial Banks registered in India, Notary Public, Court Magistrate, Judge, Indian Embassy/Consulate General in the country where the client resides are permitted to attest the documents.

Please Submit the KYC Documents on A4 Size Paper Only.

Sample Questions

1. **As per SEBI regulations, foreign nationals are permitted to invest in Indian mutual funds, subject to KYC.**

    a. **True**
    b. False

2. **PAN Card is not required for mutual fund investments below Rs 50,000 per mutual fund per financial year, where payment is in cash.**

    a. **True**
    b. False

3. **Investments in mutual fund can be made using _____.**

    a. Cheque / DD
    b. Remittance
    c. ASBA
    d. **Any of the above**

4. **Cut-off timing guidelines are not applicable for _____.**

    a. NFOs
    b. International Funds
    c. **Both of the above**
    d. None of the above

5. **STP is a combination of SIP and SWP.**

    a. **True**
    b. False

6. **Investors' KYC details are stored in the server of _____.**

    a. AMC
    b. AMFI
    c. SEBI
    d. **KRA**

CHAPTER 8: RETURN, RISK & PERFORMANCE OF FUNDS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Calculation of returns in mutual fund schemes
- Risk in mutual fund schemes
- Measures of risk
- Performance of mutual fund schemes

8.1 Drivers of Returns and Risk in a Scheme

The portfolio is the main driver of returns in a mutual fund scheme. The asset class in which the fund invests, the segment or sectors of the market in which the fund will focus on, the styles adopted to select securities for the portfolio and the strategies adopted to manage the portfolio will all determine the risk and return in a mutual fund scheme. The underlying factors are different for each asset class.

8.1.1 Equity Schemes

<u>Securities Analysis Disciplines – Fundamental Analysis and Technical Analysis</u>

Equity as an asset class represents growth investment. The returns to an investor is primarily from appreciation in the value of the asset. The risk to the investor arises from the absence of defined and fixed returns from these investments which can be volatile from period to period. The returns from equity are linked to the earnings of the business. Not all businesses are successful and manage to earn return for its equity investors. It is therefore important to analyse the business and its prospects before investing in its equity. Moreover, investors have to continue to evaluate the business to ensure that it remains profitable and worthy of investment. There are two broad approaches to security analysis: fundamental and technical analysis.

Fundamental Analysis entails review of the company's fundamentals viz. financial statements, quality of management, competitive position in its product / service market etc. The analyst sets price targets, based on financial parameters like

Earnings per Share (EPS): Net profit after tax ÷ No. of equity shares

This tells investors how much profit the company earned for each equity share that they own.

Price to Earnings Ratio (P/E Ratio): Market Price ÷ EPS

When investors buy shares of a company, they are essentially buying into its future earnings. P/E ratio indicates how much investors in the share market are prepared to pay (to become owners of the company), in relation to the company's earnings. This forward PE ratio is normally calculated based on a projected EPS for a future period (also called *forward EPS)*

A company's shares are seen as expensive or otherwise by comparing it to the market PE and peer group PE ratio. A simplistic (but faulty) view is that low P/E means that a share is cheap, and therefore should be bought; the corollary being that high P/E means that a share is expensive, and therefore should be sold. In reality, the P/E may be high because the company's prospects are indeed good, while another company's P/E may be low because it is unlikely to replicate its past performance. The validity of this parameter will depend upon the robustness of the future estimates of the earnings of the company. The PE ratio needs to be recalculated every time there is a change in the earnings and its estimates.

The Price Earnings to Growth (PEG) ratio relates the PE ratio to the growth estimated in the company's earnings. A PEG ratio of one indicates that the market has fairly valued the shares, given its expected growth in earnings. A ratio less than one indicates the shares are undervalued, and greater than one indicates an overvalued share.

Book Value per Share: Net Worth ÷ No. of equity shares

This is an indicator of how much each share is worth, as per the company's own books of accounts. The accounts represent a historical perspective, and are a function of various accounting policies adopted by the company.

Price to Book Value: Market Price ÷ Book Value per Share

An indicator of how much the share market is prepared to pay for each share of the company, as compared to its book value. The drawback with this is that the book value is an accounting measure and may not represent the true value of the assets of the company.

Such financial parameters are compared across companies, normally within a sector. Accordingly, recommendations are made to buy / hold / sell the shares of the company.

As in the case of P/E ratio, most financial indicators cannot be viewed as stand-alone numbers. They need to be viewed in the context of unique factors underlying each company. The fundamental analyst keeps track of various companies in a sector, and the uniqueness of each company, to ensure that various financial indicators are understood in the right perspective.

Dividend Yield: Dividend per Share ÷ Market price per Share

This is used as a measure of the payouts received from the company, in percentage, for each rupee of investment in the share. Since dividends are not guaranteed or fixed, investors who are particular about receiving payouts look at the trend in dividend yields over a period of time. Dividend yield is considered as a parameter by conservative investors looking to identity steady and lower risk equity investments. A high dividend yield is the result of higher payout and/or lower market prices, both of which are preferred by such conservative investors.

Another way of looking at a high dividend payout is that the company may have lower investment prospects and therefore pays out the profits instead of re-investing it into the company.

Dividend yields tend to go down across stocks in a bull market and rise in a bear market.

The discipline of Technical Analysis has a completely different approach. Technical Analysts believe that price behaviour of a share over a period of time throws up trends for the future direction of the price. Along with past prices, the volumes traded indicates the underlying strength of the trend and are a reflection of investor sentiment, which in turn will influence future price of the share. Technical Analysts therefore study price-volume charts (a reason for their frequently used description as "*chartists*") of the company's shares to decide support levels, resistance levels, break outs, and other triggers to base their buy/sell/hold recommendations for a share, etc.

Both types of analysts swear by their discipline. It is generally agreed that longer term investment decisions are best taken through a fundamental analysis approach, while technical analysis comes in handy for shorter term speculative decisions, including intra-day trading. Even where a fundamental analysis-based decision has been taken on a stock, technical analysis might help decide when to implement the decision i.e. the timing.

Investment Styles – Growth and Value

Growth investment style entails investing in high growth stocks i.e. stocks of companies that are likely to grow much faster than the economy. Many market players are interested in accumulating such *growth stocks*. Therefore, valuation of these stocks tends to be on the higher side. Further, in the event of a market correction, these stocks tend to decline more. Such stocks typically feature high PE and PEG ratios and lower dividend yield ratio.

Value investment style is an approach of picking up stocks, which are priced lower than their intrinsic value, based on fundamental analysis. The belief is that the market has not appreciated some aspect of the value in a company's share – and hence it is cheap. When the market recognizes the intrinsic value, then the price would shoot up. Such stocks are also called *value stocks.* Investors need a longer investment horizon to benefit from the price appreciation in such stocks.

Value investors maintain a portfolio of such value stocks. In the stocks where their decision is proved right, they earn very high returns, which more than offset the losses on failed decisions.

It is important to note that 'high valuation' is not the equivalent of 'high share price', just as 'low valuation' is not the same as 'low share price'. Fundamental analysts look at value in the context of some aspect of the company's financials. For example, how much is the share price as compared to its earnings per share (*Price to Earnings Ratio*); or how much is the share price as compared to its book value (*Price to Book Value Ratio*).

Thus, a company's share price may be high, say Rs100, but still reasonably valued given its earnings; similarly, a company may be seen as over-valued, even when its share price is Rs5, if it is not matched by a reasonably level of earnings.

Investments of a scheme can thus be based on growth, value or a blend of the two styles. In the initial phases of a bull run, growth stocks deliver good returns. Subsequently, when the market heats up and the growth stocks get highly valued or costly, value picks end up being safer.

Portfolio building approach – Top down and Bottom up

In analysing the factors that impact the earnings of company, analysts consider the economy, the industry and the company-specific factors. Economic factors include inflation, interest rates, GDP growth rates, fiscal and monetary policies of the government, balance of payment and such. Industry factors that are relevant include regulations that affect investment and growth decisions of the companies, level of competition, availability of raw materials and other inputs and cyclical nature of the industry. Company-specific factors include management and ownership structure, financial parameters, products and market shares and others.

In a *top down* approach, the portfolio manager evaluates the impact of economic factors first and narrows down on the industries that are suitable for investment. Thereafter, the companies are analysed and the good stocks within the identified sectors are selected for investment.

A *bottom-up* approach on the other hand does analyses the company-specific factors first and then evaluates the industry factors and finally the macro-economic scenario and its impact on the companies that are being considered for investment. Stock selection is the key decision in this approach; sector allocation is a result of the stock selection decisions.

Both approaches have their merit. Top down approach minimizes the chance of being stuck with large exposure to a poor sector. Bottom up approach ensures that a good stock is picked, even if it belongs to a sector that is not so hot. What is important is that the approach selected should be implemented professionally.

Therefore, it can be said that equity returns are a function of sector and stock selection. Investors can also hope for a secular growth in a diversified mix of equity stocks when the economy does well.

8.1.2 Debt

Investment in a debt security, as in the case of a loan, entails a return in the form of interest (at a pre-specified frequency for a pre-specified period), and refund of a pre-specified amount at the end of the pre-specified period.

The pre-specified period is also called *tenor.* At the end of the tenor, the securities are said to *mature*. The process of repaying the amounts due on maturity is called *redemption.*

Debt securities that are to mature within a year are called money market securities.

The return that an investor earns or is likely to earn on a debt security is called its *yield.* The yield would be a combination of interest paid by the issuer and capital gain (if the proceeds on redemption are higher than the amount invested) or capital loss (if the proceeds on redemption are lower than the amount invested) relative to the price paid to buy the security.

Debt securities may be issued by Central Government, State Governments, Banks, Financial Institutions, Public Sector Undertakings (PSU), Private Companies, Municipalities, etc.

- Securities issued by the Government are called *Government Securities* or *G-Sec* or *Gilt*.
- *Treasury Bills* are short term debt instruments issued by the Reserve Bank of India on behalf of the Government of India.
- *Certificates of Deposit* are issued by Banks (for 91 days to 1 year) or Financial Institutions (for 1 to 3 years)
- *Commercial Papers* are short term securities (upto 1 year) issued by companies.
- *Bonds / Debentures* are generally issued for tenors beyond a year. Governments and public sector companies tend to issue bonds, while private sector companies issue debentures.

Since the government is unlikely to default on its obligations, Gilts are viewed as safe and there is no credit risk associated with them. The yield on Gilt is generally the lowest in the market for a given tenor. Since non-Government issuers can default, they tend to offer higher yields for the same tenor. The difference between the yield on Gilt and the yield on a non-Government Debt security is called its *credit spread.*

The possibility of a non-government issuer defaulting on a debt security i.e. its credit risk is measured by Credit Rating companies like CRISIL, ICRA, CARE and Fitch. They assign different symbols to indicate the credit risk in a debt security. For instance 'AAA' is CRISIL's indicator of highest safety in a debenture. Higher the credit risk, higher is likely to be the yield on the debt security. Most of us are familiar with this concept with respect to the company fixed deposits. The interest rate offered by these deposits depends on the credit rating assigned.

The interest rate payable on a debt security may be specified as a fixed rate, say 6%. Alternatively, it may be a floating rate i.e. a rate linked to some other rate that may be prevailing in the market, say the rate that is applicable to Gilt. Interest rates on floating rate securities (also called *floaters)* are specified as a "Base + Spread". For example, 5-year G-Sec + 2%, this means that the interest rate that is payable on the debt security would be 2% above whatever is the rate prevailing in the market for Government Securities of 5-year maturity.

The returns in a debt portfolio are largely driven by interest rates and credit spreads.

Interest Rates

Suppose an investor has invested in a debt security that yields a return of 8%. Subsequently, yields in the market for similar securities rise to 9%. It stands to reason that the security, which was bought at 8% yield, is no longer such an attractive investment. It will therefore lose value. Conversely, if the yields in the market go down, the debt security will gain value. Thus, there is an inverse relationship between yields and value of such debt securities, which offer a fixed rate of interest.

Let us look at another example:

Suppose Company X issued a debenture for a period of 5 years carrying a coupon rate of 9.5% p.a. The debenture carried credit rating of AAA, which denotes highest safety.

2 years later, the debenture has residual maturity of 3 years, i.e. the debenture will mature after 3 years. At this stage, the interest rate for AAA rated debentures having 3-year maturity is 8.5% p.a. In such a case, the Company X debenture would fetch premium in the secondary market over its face value.

A security of longer maturity would fluctuate a lot more, as compared to short tenor securities. Debt analysts' work with a related concept called *modified duration* to assess how much a debt security is likely to fluctuate in response to changes in interest rates. Higher the modified duration of a debt security, greater is the volatility in its prices in response to changes in interest rates in the market.

In a floater, when yields in the market go up, the issuer pays higher interest; lower interest is paid, when yields in the market go down. Since the interest rate itself keeps adjusting in line with the market, these floating rate debt securities tend to hold their value, despite changes in yield in the debt market.

If the portfolio manager expects interest rates to rise, then the portfolio is switched towards a higher proportion of floating rate instruments; or fixed rate instruments of shorter tenor (which have lower modified duration). On the other hand, if the expectation is that interest rates would fall, then the manager increases the exposure to longer term fixed rate debt securities (which have higher modified duration).

The calls that a fund manager takes on likely interest rate scenario are therefore a key determinant of the returns in a debt fund – unlike equity, where the calls on sectors and stocks are important.

Credit Spreads

Suppose an investor has invested in the debt security of a company. Subsequently, its credit rating improves. The market will now be prepared to accept a lower credit spread. Correspondingly, the value of the debt security will increase in the market.

A debt portfolio manager explores opportunities to earn gains by anticipating changes in credit quality, and changes in credit spreads between different market benchmarks in the market place.

8.1.3 Gold

Gold is a truly international asset, whose quality can be objectively measured. The value of gold in India depends on the international price of gold (which is quoted in foreign currency), the exchange rate for converting the currency into Indian rupees, and any duties on the import of gold.

Therefore, returns in gold as an asset class depends on:

Global price of gold

Gold is seen as a safe haven asset class. Therefore, whenever there is political or economic turmoil, gold prices shoot up.

Most countries hold a part of their foreign currency reserves in gold. Similarly, institutions like the International Monetary Fund have large reserves of gold. When they come to the market to sell, gold prices weaken. Purchases of gold by large countries tend to push up the price of gold.

Strength of the Rupee

Economic research into inflation and foreign currency flows helps analysts anticipate the likely trend of foreign currency rates.

When the rupee becomes stronger, the same foreign currency can be bought for fewer rupees. Therefore, the same gold price (denominated in foreign currency), translates into a lower rupee value for the gold portfolio. This pushes down the returns in the gold fund. A weaker rupee, on the other hand, pushes up the rupee value of the gold portfolio, and consequently the returns in gold would be higher.

8.1.4 Real Estate

Unlike gold, real estate is a local asset. It cannot be transported – and its value is driven by local factors. Some of these factors are:

Economic scenario

In the recent past, when there was uncertainty about the economy, people preferred to postpone real estate purchases. Consequently, real estate prices weakened. As the economy improves, real estate prices also tend to keep pace.

Infrastructure development

Whenever infrastructure in an area improves, real estate values go up.

Interest Rates

When money is cheap and easily available, more people buy real estate. This pushes up real estate values. Rise in interest rates therefore softens the real estate market.

The behaviour of real estate is also a function of the nature of real estate viz. residential or commercial; industrial, infrastructural, warehouse, hotel or retail.

Similarly, a lot of innovation is possible in structuring the real estate exposure. Real estate analysts are experts in assessing the future direction of different kinds of real estate, and structuring exposure to them.

The portfolio is the most important driver of returns in a scheme. The factors that drive the return of some of the asset classes were discussed here. The factors that cause fluctuation in the returns of these asset classes, and the schemes that invest in them, are discussed in a later section on risk drivers.

8.2 Measures of Returns

The returns from an investment is calculated by comparing the cost paid to acquire the asset (outflow) or the starting value of the investment to what is earned from it (inflows) and computing the rate of return. The inflows can be from periodic pay outs such as interest from fixed income securities and dividends from equity investments and gains or losses from a change in the value of the investment. The calculation of return for a period will take both the income earned and gains/loss into consideration, even if the gains/loss have not been realized.

8.2.1 Simple Return

Whatever the nature of a mutual fund scheme, its value is reflected in the NAV.

Suppose you invested in a scheme, when its NAV was Rs 12. Later, you found that the NAV has grown to Rs 15. How much is your return?

The *Simple Return* can be calculated with the following formula:

$$\frac{(\textbf{LaterValue}\mathit{minus}\textbf{InitialValue}) \times 100}{\textbf{InitialValue}}$$

$$\frac{(\textbf{Rs15}\mathit{minus}\textbf{Rs12}) \times 100}{\textbf{Rs12}}$$

i.e. **25%**

Thus, simple return is simply the change in the value of an investment over a period of time.

8.2.2 Annualized Return

Two investment options have indicated their returns since inception as 5% and 3% respectively. If the first investment was in existence for 6 months, and the second for 4 months, then the two returns are obviously not comparable. Annualization helps us compare the returns of two different time periods.

The *annualized return* can be calculated as:

$$\frac{\textbf{Simple Return} \times 12}{\textbf{Period of Simple Return}\ (\text{in months})}$$

Investment 1	**Investment 2**
$\frac{5\% \times 12}{6}$	$\frac{3\% \times 12}{4}$
i.e. **10%**	i.e.**9%**

8.2.3 Compounded Return

If the two investment options mentioned above were in existence for 6 years and 4 years respectively, then it is possible to calculate the annualised return using the above formula. However, the effect of *compounding* is missed.

What is compounding? Suppose you place Rs 10,000 in a cumulative bank deposit for 3 years at 10% interest, compounded annually.

The bank would calculate the interest in each of the 3 years as follows:

Year	Opening Balance (Rs)	Interest (10% on opening)	Closing Balance (Rs)
1	10,000	1,000	11,000
2	11,000	1,100	12,100

Year	Opening Balance (Rs)	Interest (10% on opening)	Closing Balance (Rs)
3	12,100	1,210	13,310

Thus, at the end of the 3 year period, your principal of Rs 10,000 would have grown to Rs 13,310. If, on the other hand, the bank had calculated interest on simple basis, it would have calculated interest at Rs 1,000 for each of the 3 years, and given you Rs 13,000.

The difference between Rs 13,310 and Rs 13,000 is the effect of compounding. Longer the period of investment holding, higher would be the error, if compounding is not considered.

Compounded return can be calculated using a formula:

$$\frac{LV}{IV}^{1/n} - 1$$

Where, 'LV' is the Later Value; 'IV' is the Initial Value; and 'n' is the period in years.

Thus, if Rs 1,000 grew to Rs 4,000 in 2 years, LV = Rs 4,000; IV = Rs 1,000; n = 2 years, then the compounded return is given by the formula:

$$\frac{Rs\ 4{,}000}{Rs\ 1{,}000}^{1/2} - 1$$

Students who are not familiar with such exponential functions can arrive at the answer using MS Excel, by putting down the following formula in a cell:

= ((4000/1000)^(1/2))-1

MS Excel will calculate the answer to be 1. This is equivalent to 1 X 100 i.e. 100%. Thus, the investment yielded a 100% compounded return during the 2 years.

Logically, for a return of 100%, the initial value of Rs 1,000 should have grown by 100% i.e. doubled to Rs 2,000 in the first year; and further doubled to Rs 4,000 in the second year. Thus LV had to reach a value of Rs 4,000, which indeed was the case.

8.2.4 Compounded Annual Growth Rate (CAGR)

It is possible to do the above calculations, by using the concerned NAVs of a scheme. Thus, if you were calculating the returns from a scheme over a specific period of time, then:

- NAV at the beginning of the period is 'IV';
- NAV at the end of the period is 'LV'; and
- Exact number of days during the period, divided by 365 is 'n'

Conceptually, these calculations give you only the return in the form of change in NAV. Another form of return for an investor in a mutual fund scheme is dividend. As seen in Chapter 6, NAV goes down after a dividend is paid. Therefore, in the above examples, if a dividend were paid, then that has not been captured in any of the three kinds of returns calculated viz. Simple, Annualised and Compounded.

The above three formulae are thus applicable only for growth schemes, or for dividend schemes that have not paid a dividend during the period for which return is being calculated.

Whenever a dividend is paid – and compounding is to be considered - the CAGR technique prescribed by SEBI is used. This calculation is based on an assumption that the dividend would be re-invested in the same scheme at the ex-dividend NAV. The following example will clarify the calculation.

You invested Rs 10,000 in a scheme at Rs 10 per unit on June 30, 2013

On January 1, 2014, the scheme paid out a dividend of Rs 1 per unit. The ex-dividend NAV was Rs 12.50.

On January 1, 2015, the scheme paid out another dividend of Rs 1 per unit. The ex-dividend NAV was Rs 15.00.

Let us calculate the CAGR, which we know captures the impact of both dividend payments and compounding.

We know that 'IV', the initial value of investment is Rs 10,000.

If Rs 10,000 was invested at Rs 10 per unit, then you would have 1,000 units.

The first dividend of Rs 1 per unit on 1,000 units would amount to Rs 1,000. If this amount were re-invested in the same scheme at the ex-dividend NAV, then you would have Rs 1,000 ÷ Rs 12.50 i.e. 80 additional units.

Thus, your unit-holding would have gone up from 1,000 to 1,080 units.

The second dividend of Rs1 per unit, on the revised unit-holding of 1,080 units would amount to Rs 1,080. If this amount were re-invested in the same scheme at the ex-dividend NAV, then you would have Rs 1,080 ÷ Rs 15.00 i.e. 72 additional units.

Thus, your unit-holding would have gone up from 1,080 to 1,152 units. At Rs15 per unit, this would be valued at Rs 17,280.

'LV', the later value of units is thus Rs 17,280.

The impact of dividend has been captured in the form of increase in the number of units.

You now need the time period in years, to compute the compounded returns. The period of June 30, 2013 to January 1, 2015 has 550 days. Dividing by 365, it translates to 1.51 years.

Now the compound interest formula can be applied.

$$\frac{LV}{IV}^{1/n} - 1$$

Where, 'LV' is the Later Value; 'IV' is the Initial Value; and 'n' is the period in years.

Here, Rs10,000 grew to Rs17,280 in 1.51 years, LV = Rs17,280; IV = Rs10,000; n = 1.51 years. CAGR is calculated by the formula:

$$\frac{Rs17{,}280}{Rs10{,}000}^{1/1.51} - 1$$

The answer can be calculated using MS Excel, by putting down the following formula in a cell:

= ((17280/10000)^(1/1.51))-1

MS Excel will calculate the answer to be 0.4365. This is equivalent to 0.4365 X 100 i.e. 43.65%. Thus, the investment yielded a 43.65% CAGR between June 30, 2008 and January 1, 2010.

8.2.5 SEBI Norms regarding Representation of Returns by Mutual Funds in India

Mutual funds are not permitted to promise any returns, unless it is an assured returns scheme. Assured returns schemes call for a guarantor who is named in the offer document. The guarantor will need to write out a cheque, if the scheme is otherwise not able to pay the assured return.

The SEBI Advertising Code was discussed in Chapter 5.

8.2.6 Scheme Returns and Investor Returns

Scheme Returns & Investor Returns

The discussion so far focused on scheme returns. Investors might have a return profile that is different, on account of the role of loads.

In the earlier example, the CAGR was calculated with the closing NAV as Rs 15. However, if an exit load of 1% was applicable, then you will receive only 99% of Rs 15 i.e. Rs 14.85 on re-purchase. Thus, your return as investor would be lower than the scheme returns.

Similarly, if the original investment had suffered an entry load of 2%, you would have bought the units at 102% of Rs10 i.e. Rs 10.20. This would have brought down the returns. (Fortunately for the investor, entry load is no longer permitted).

Loads thus drag the investor's return below the scheme return.

Chapter 6 discussed the role of taxes. This again can pull down the investor's post-tax returns.

While calculating investor returns for a period, the same formulae can be used, with the following changes:

- Instead of 'IV', the initial value of NAV (which is used for calculating scheme returns), the amount actually paid by the investor (i.e. NAV plus Entry Load, if any) would need to be used

- Instead of 'LV', the later value of NAV (which is used for calculating scheme returns), the amount actually received / receivable by the investor (i.e. NAV minus Exit Load, if any) would need to be used.

Investor returns might vary from the scheme returns also on account of choices regarding investment schedule, i.e, additional investment being made during the period or redeeming a portion of the investment. In such a case, for the same period investor's returns may be different from the published return of the scheme.

The returns published in a mutual fund advertisement would be without factoring the entry or exit load, as may be applicable.

Holding period returns is calculated for a fixed period such as one month, three month, one year, three years or since inception. The return is calculated using CAGR if the holding period is over one year and simple absolute returns for less than one year. Holding period returns may not present an accurate picture of the returns from a fund if the initial value or the end value used for calculation was too high or low. To eliminate this impact rolling returns are calculated. Rolling returns is the average annualized return calculated for multiple consecutive holding period in an evaluation period. For example, all consecutive one year returns in a three year period with a daily/weekly/monthly rollover is calculated and averaged.

8.3 Drivers of Risk in a Scheme

8.3.1 Risk in Mutual Fund Schemes

Portfolio Risk

Investors invest in a mutual fund scheme, which in turn invests in the market – debt, equity, gold or real estate in varying mixes, depending on the nature of the scheme. There is no certainty regarding the performance of the market/s, where a fund invests. Valuation in the market may go up or go down. Accordingly, the value of the portfolio and the NAV of the scheme fluctuate. Since mutual fund returns are subject to such fluctuation, the KIM of any scheme would mention the following:

"Mutual Fund Units involve investment risks including the possible loss of principal. Please read the SID carefully for details on risk factors before investment. Scheme specific Risk Factors are summarized below:" Risk factors specific to the scheme are then explained below this paragraph, in the KIM.

Further, one of the standard risk factors mentioned in any SID is "Past performance of the Sponsor / AMC / Mutual Fund does not guarantee future performance of the scheme"

Despite the risk, investment in mutual fund schemes is not a gamble. As was seen earlier, investments can be managed professionally. Various investments have different levels of risk. Astute fund managers understand the inherent risks. Thus, they can design portfolios that seek to moderate or enhance the risk as per the investment philosophy of each scheme.

Further, quantitative tools are available for portfolio optimization. Blind faith in such tools can be dangerous, because most of these tools rely on past behaviour of the markets.

Investment astuteness, backed by quantitative indicators, goes a long way in balancing the risk, and managing the downside arising out of those risks.

Portfolio Liquidity

When investments are liquid, there is a transparent market benchmark to its value. Further, these investments can be sold easily if it is expected to perform poorly, or to book profits or to generate liquidity for the scheme.

SEBI has therefore laid down criteria to identify illiquid investments, and also set a ceiling to the proportion of such illiquid investments in the net assets of a scheme. The prescribed ceiling is lower for open-ended scheme, which have a greater need for liquidity because investors can offer their units for re-purchase at any time.

In 2008 and 2009, when the global markets went into turmoil, liquidity disappeared from the market. RBI had to step in to help some mutual funds fulfil their obligations.

In order to provide for eventualities, most open-end schemes in their Offer Document, reserve the right to limit or stop re-purchases in extreme cases of financial market illiquidity or volatility.

Liquid assets in the scheme

Schemes maintain a certain proportion of their assets in liquid form. This could be for either of two reasons

- They believe that the market is over-heated, and therefore prefer to sell their investments and hold the proceeds in liquid form, until the next buying opportunity comes up. However, timing the market may work against the investor's interest too if markets continue to rise after the scheme has moved into liquid assets, or the fund managers are not able to buy into the securities when the market is low. This is a risky strategy to follow.

- They want to provide for contingencies such as impending dividend payment or re-purchase expectations.

Since liquid assets generally yield a lower return, they can be a drag on the scheme returns, if the other assets in the market perform better. However they protect the scheme from any distress sale of investments.

Liabilities in the scheme

As was seen in Chapter 6, NAV is calculated as Net Assets divided by number of units. Any scheme's net asset is the difference between its total assets, and it's outside liabilities i.e. liabilities other than to Unit holders.

The investment portfolio represents the major chunk of total assets in any scheme's portfolio. The portfolio, as we saw, is subject to market risk.

The outside liabilities need to be paid by a scheme, irrespective of the performance of the assets. It is bad enough when the assets perform poorly, but if heavy outside liabilities need to be paid during that time, the scheme faces extreme pressure. Therefore, outside liabilities add to the risk in a mutual fund scheme.

Some outside liabilities are part of the business. For example, when a scheme purchases an investment, it is liable to pay for it. Until the payment is made as per the stock exchange settlement cycle, it will be a liability of the scheme. The practice of taking liabilities beyond what is inherent to the normal business of a mutual fund scheme is called *leveraging.* Internationally, such leveraged funds are commonly found.

Recognising the risks involved in such leveraging, SEBI regulations stipulate that:

- A mutual fund scheme cannot borrow more than 20% of its net assets
- The borrowing cannot be for more than 6 months.
- The borrowing is permitted only to meet the cash flow needs of investor servicing viz. dividend payments or re-purchase payments.

The limitations on leveraging ensure that risks arising out of balance sheet structure in Indian mutual fund schemes is considerably minimised.

Use of Derivatives

Derivatives are instruments whose value is derived from the value of one or more underlying exposures. The underlying could be a shares, exchange rate, interest rate, commodity, precious metal, index, weather, etc. The commonly known derivatives are forwards, futures, options and swaps.

As an illustration, a gold futures contract is discussed in Chapter 10. A discussion on these products is otherwise beyond the scope of this Workbook. But it is important to understand that these products may be used for either of the following purposes:

- ***Hedging against risk***

Some derivative contracts are structured such that, when the market goes down the derivative contract will earn money for the investor. Thus, the derivative contract can make up for a decline in the value of the investment portfolio of a mutual fund scheme. This is a useful risk management approach.

- ***Re-balancing the portfolio***

A mutual fund scheme that wants to vary the weightage of a sector, say, pharma, in its portfolio, can do so through derivatives, without having to sell some non-pharma companies' shares, and buying some pharma companies' shares. This can be an economical way of managing the investment exposures.

Leveraging

Leveraging is taking large positions with a small outlay of funds. This point is explained in the context of Gold Futures in Chapter 10, where, based on an initial investment of Rs 15,000, exposure is taken to gold worth Rs 300,000 i.e. 20 times the value of the initial investment.

If a mutual fund decides to use its corpus of, say, Rs 1,000 crore, to take exposures of 20 times that amount viz. Rs 20,000 crore, then a huge risk is being taken. Even if the investments were to decline in value by 5%, the loss would be Rs 20,000 crore X 5% i.e. Rs 1,000 crore, effectively wiping out the capital of the scheme.

Mutual funds are permitted to use derivatives for hedging against risk or re-balancing the portfolio, but not for leveraging.

Investment in derivatives would have to be specifically permitted in the Offer Document. If not already provided for in the offer document, approval of investors would need to be taken, before the scheme can invest in derivatives.

Mutual Funds are barred from writing options (they can buy options) or purchasing instruments with embedded written options.

Unit-holder Churn

If an investor in an open-ended scheme offers his units for re-purchase, then the scheme needs to pay the investor. When such re-purchases go beyond the level of liquid assets, and inflows through sale of new units, the scheme is forced to sell investments in its portfolio to generate the liquidity.

There have been occasions where institutional investors have suddenly offered a large number of units for re-purchase during difficult market conditions. The liquidity pressures force the scheme to sell assets below their intrinsic value. Consequently, retail investors suffer for no fault of theirs.

Mutual fund investors need to be cautious about schemes where the unit-holding is not widely distributed. As a measure to protect the investor, SEBI has stipulated the 20:25 rule viz. every scheme should have at least 20 investors; no investor should represent more than 25% of net assets of a scheme.

The above are key drivers of risk in all mutual fund schemes. Besides, each category of schemes has inherent risks, which flow from the uniqueness of the markets they invest in.

8.3.2 Risk in Equity Funds

Generic

Equity markets seek to reflect the value in the real economy. In performing this role, the following significant risks come up:

- The real economy goes through cycles. For a few years until 2008, the economy was booming. Then things started changing. 2009 was gloomy. However, during 2010 an economic recovery is being seen.
- In the long run, equity markets are a good barometer of the real economy – but in the short run, markets can get over-optimistic or over-pessimistic, leading to spells of greed and fear.
- The returns from equity investments are not fixed or guaranteed. Evaluation, selection and monitoring of sectors and companies are important to equity fund investing.

Equity markets therefore tend to be volatile.

Portfolio Specific

The nature of the portfolio influences scheme risk as follows:

Sector funds suffer from concentration risk - the entire exposure is to a single sector. If that sector does poorly, then the scheme returns are seriously affected. Sector funds are considered to carry the highest risk among the equity mutual funds.

Diversified equity funds, on the other hand, have exposure to multiple sectors and companies. Thus, even if a few sectors or companies perform poorly, other better performers can make up. Diversified equity funds are therefore less risky than sector funds. Some funds are launched as focussed funds which invest in a limited number of companies. The selection risk is high in such funds since a larger proportion of the fund's asset is concentrated in each company and poor performance can have a significant impact on the scheme's returns.

Thematic funds are a variation of sector funds. Here the investment is as per a theme, say infrastructure. Multiple sectors, such as power, transportation, cement, steel, contracting and real estate are connected to infrastructure. Thus, a thematic fund tends to have wider exposure than a sector fund, but a narrower exposure than a diversified fund. Therefore, thematic funds are less risky than sector funds, but riskier than diversified equity funds.

Mid cap funds invest in mid cap stocks, which are less liquid and less researched in the market, than the frontline stocks. Therefore, the liquidity risk is high in such portfolios. Further, since they are intrinsically not as strong as the frontline stocks, they become riskier during periods of economic turmoil and many of them are liable to fail. These stocks see greater volatility in prices. Large cap stocks on the other hand typically represent companies with stable revenues and earnings. These stocks are highly liquid and the price of these stocks are not as volatile as mid and small cap stocks.

Contra funds take positions that are contrary to the market. Such an investment style has a high risk of misjudgements.

Dividend yield funds invest in shares whose prices fluctuate less, but offer attractive returns in the form of dividend. Such funds offer equity exposure with lower downside.

Arbitrage funds are categorized as equity funds because they invest in equity. In reality, the risks are arbitraged (i.e. cancelled out), normally between the cash market and the F&O market. Therefore, the risk in this category of funds turns out to be the lowest among equity funds – even lower than diversified equity funds. The returns too are lower – more in line with money market returns, rather than equity market returns.

However, one should not forget the *risk* in an arbitrage fund – the risk that both cash and F&O position on a company cannot be reversed at the same time. During the time gap between unwinding of the two positions, the market can move adverse to the scheme.

Investment styles adopted by the fund manager will also reflect on the risk of the portfolio. A growth style will look for stocks expected to have growth in earnings and profitability higher than the economy. The risk of loss is also higher in such stocks. Value style is a conservative style seeks to identify stocks that are priced lower since they are undervalued by the markets. Such stocks feature lower volatility in price.

Portfolio Turnover is the extent of churn in the portfolio of the fund. Portfolio turnover ratio is calculated as Value of Purchase and Sale of Securities during a period divided by the average size of net assets of the scheme during the period.

A high portfolio turnover ratio relative to similar funds indicates an aggressively managed portfolio. It means the holding period of the securities in the portfolio is low and the fund manager may believe in buying and selling stocks to book profits and time the market. This is a risky strategy with a short-term perspective.

8.3.3 Risk in Debt Funds

Generic

Unlike equity, debt securities are repayable on maturity. Thus, whatever the imperfections in the market, a solvent issuer will still repay the amount promised, on maturity. This assured value on maturity makes debt a lot safer than equity.

Despite the assured value on maturity, debt securities fluctuate in value, with changes in yield in the overall market. The interest rates in the economy are influenced by factors beyond the control of any single entity. Policies of the government and RBI are unpredictable, and these too influence interest rates. A fund manager taking a wrong call on the direction of interest rates can seriously affect the scheme performance. Similarly, investment in non-government debt instruments has a credit risk associated with it. The issuer may fail to make the payments as scheduled on interest and principal repayment. A fall in the credit quality will see the value of the securities declining.

The debt market, especially the non-government segment, is not as vibrant and liquid as the equity market. Therefore, there is the possibility of not finding a buyer for the securities held. Similarly, when securities are not traded in the market, an element of subjectivity creeps into their valuation and therefore the NAV.

SEBI has laid down detailed portfolio valuation guidelines to limit the risks associated with liquidity and enhance the transparency of NAV. The interest rate risk and credit risk in a scheme will depend upon the investment objective and therefore the portfolio of the scheme.

Portfolio Specific

Short maturity securities suffer lesser fluctuation in value, as compared to the ones with longer tenor. Therefore, liquid schemes, which invest in securities of upto 91 days maturity, have the lowest risk amongst all kinds of schemes. Short-term funds primarily invest in securities with maturities of less than one year. The principal source of returns in such funds is the interest earned rather than the gains from a change in the value of the securities. This makes their return more stable and less volatile.

Gilt schemes, which invest in only government securities, have a higher price risk because their NAV can fluctuate a lot more, on account of changes in yield in the market. Greater the proportion of longer maturity securities in the portfolio, higher would be the fluctuation in NAV. Bond funds may take on higher credit risk by investing in lower rated instruments to earn higher coupon income or to benefit from an increase in prices if the rating improves. However this increases the risk of default in the scheme.

Since Fixed Maturity Plans (FMP) align the maturity of their portfolio to the maturity of the scheme, the yield is relatively more predictable. However, such predictability is only on maturity, when the investee company will repay the principal on the securities to the scheme. In the interim, the value of these securities will fluctuate in line with the market – and therefore, the scheme’s NAV too will fluctuate. If the FMP is structured on the basis of investment in non-government paper, then the credit risk is an issue.

When the real estate sector was in financial trouble recently, several mutual fund debt schemes faced the pressure, because they had large exposures to the sector. Portfolio concentration, in a company or a sector, enhances the risk profile of a scheme. This can be a bigger concern in Liquid Schemes, Monthly Income Plans and Fixed Maturity Plans, where the investors do not anticipate the risk.

While an equity share is an equity share, several variants of debt securities are possible. Advanced computing technology makes it possible to ‘slice and dice’ debt securities and create complex structures in innovative ways. In pursuit of innovation, instruments are created and traded, without the intellectual rigour that has improved our understanding of traditional debt instruments.

In the case of specific structures like securitized debt, it is not possible for the investor to study the debtors whose obligations support the securitization. Greater reliance therefore needs to be placed on the credit rating agencies, who rate the securitized debt portfolio.

During the last two years, it was seen that global regulators and rating agencies had not fully understood the risk profile of some of the instruments they had approved or rated.

A pure capital guaranteed scheme is one where the guarantee comes out of sovereign debt i.e. government securities, which mature to the requisite value on or before the closure of the scheme. Schemes where the capital guarantee is based on investment in non-sovereign debt, even if it is an AAA-rated portfolio, have a credit risk. Therefore, the capital guarantee cannot be taken for granted. There are therefore in the nature of capital protection oriented schemes rather than capital guaranteed schemes.

A particularly risky category of debt funds is junk bond schemes. Also called high yield bond schemes, they invest in securities of poor credit quality. SEBI Regulations however limit the exposure that mutual fund schemes can take to unrated debt securities, and debt securities that are below investment grade. Therefore, this risky category of mutual fund scheme is not offered by Indian mutual funds.

8.3.4 Risk in Hybrid Funds

Hybrid funds invest in a mix of debt and equity. It is rare for both debt and equity markets to fare poorly at the same time. Since the performance of the scheme is linked to the performance of these two distinct asset classes, the risk in the scheme is reduced through diversification across asset classes.

Monthly Income Plan, as seen in Chapter 1, is a hybrid fund that seeks to combine a large debt portfolio with a yield-kicker in the form of an equity component. In such a structure, it is possible that losses in the equity component eat into the profits in the debt component of the portfolio. If the scheme has no profits to distribute, then no dividend will be declared. Thus, the investor may not get the monthly income implicit in the name Monthly Income Plan.

Some hybrid schemes offer significant asset allocation flexibility to the fund manager. They can switch a large part of their portfolio between debt and equity, depending on their view on the respective markets. This kind of scheme is called *flexible asset allocation scheme.* These are risky for investors, because there is always the risk that the fund manager takes a wrong asset allocation call. Between fixed asset allocation funds and flexible asset allocation funds, the latter carry higher risk.

Further, investors do not know whether they are investing in a debt scheme or an equity scheme. Therefore, investors do not have clarity on whether to treat it as equity or debt, in the asset allocation for their financial plan.

8.3.5 Risk in Gold Funds

As an international commodity, gold prices are a lot more difficult to manipulate. Therefore, there is better pricing transparency.

Further, gold does well when the other financial markets are in turmoil. Similarly, when a country goes into war, and its currency weakens, gold funds give excellent returns.

These twin benefits make gold a very attractive risk proposition. An investor in a gold fund needs to be sure what kind of gold fund it is – Gold Sector Fund or ETF Gold.

8.3.6 Risk in Real Estate Funds

- Every real estate asset is different. Valuation of real estate assets is therefore highly subjective.
- Real estate transactions suffer the curse of black money. Transparency is therefore an issue.
- Real estate is a less liquid asset class. The intermediation chain of real estate agents is largely unorganized.

- Transaction costs, in the form of stamp duty, registration fees, etc. are high.
- Regulatory risk is high in real estate, as is the risk of litigation and other encumbrances.
- The transparency level is low even among the real estate development and construction companies. Many are family-owned and family-driven. Poor corporate governance standards increase the risks in investing in their securities.

Thus, real estate funds are quite high in risk, relative to other scheme types. Yet, they are less risk than direct investment in real estate.

8.4 Measures of Risk

Fluctuation in returns is used as a measure of risk. Therefore, to measure risk, generally the periodic returns (daily / weekly / fortnightly / monthly) are first worked out, and then their fluctuation is measured against the average return. The fluctuation or variation may be to the higher or lower side. Both are taken as risky. The fluctuation in returns can be assessed in relation to itself, or in relation to some other index. Accordingly, the following risk measures are commonly used.

8.4.1 Variance

Suppose there were two schemes, with monthly returns as follows:

Scheme 1:	5%, 4%, 5%, 6%.	Average=5%
Scheme 2:	5%, -10%, +20%, 5%	Average=5%

Although both schemes have the same average returns, the periodic (monthly) returns fluctuate a lot more for Scheme 2. Variance measures the fluctuation in periodic returns of a scheme, as compared to its own average return. This can be easily calculated in MS Excel using the following function:

=var(range of cells where the periodic returns are calculated)

Variance as a measure of risk is relevant for both debt and equity schemes.

8.4.2 Standard Deviation

Like Variance, Standard Deviation too measures the fluctuation in periodic returns of a scheme in relation to its own average return. Mathematically, standard deviation is equal to the square root of variance.

This can be easily calculated in MS Excel using the following function:

=stdev(range of cells where the periodic returns are calculated)

Standard deviation as a measure of risk is relevant for both debt and equity schemes.

8.4.3 Beta

Beta is based on the *Capital Assets Pricing Model (CAPM)*, which states that there are two kinds of risk in investing in equities – *systematic risk* and *non-systematic risk*.

Systematic risk is integral to investing in the market; it cannot be avoided. For example, risks arising out of inflation, interest rates, political risks etc. This arises primarily from macro-economic and political factors. This risk cannot be diversified away.

Non-systematic risk is unique to a company; the non-systematic risk in an equity portfolio can be minimized by diversification across companies. For example, risk arising out of change in management, product obsolescence etc.

Since non-systematic risk can be diversified away, investors need to be compensated only for systematic risk, according to CAPM. This systematic risk is measured by its *Beta.*

Beta measures the fluctuation in periodic returns in a scheme, as compared to fluctuation in periodic returns of a diversified stock index over the same period.

The diversified stock index, by definition, has a Beta of 1. Companies or schemes, whose beta is more than 1, are seen as more risky than the market. Beta less than 1 is indicative of a company or scheme that is less risky than the market.

Beta as a measure of risk is relevant only for equity schemes.

8.4.4 Modified Duration

As seen earlier, this measures the sensitivity of value of a debt security to changes in interest rates. Higher the modified duration, higher the interest sensitive risk in a debt portfolio.

A professional investor would rely on modified duration as a better measure of sensitivity to interest rate changes.

8.4.5 Weighted Average Maturity

While modified duration captures interest sensitivity of a security better, it can be reasoned that longer the maturity of a debt security, higher would be its interest rate sensitivity. Extending the logic, weighted average maturity of debt securities in a scheme's portfolio is indicative of the interest rate sensitivity of a scheme.

Being simpler to comprehend, weighted average maturity is widely used, especially in discussions with lay investors. However, a professional debt fund manager would rely on modified duration as a better measure of interest rate sensitivity.

8.4.6 Credit Rating

The credit rating profile indicates the credit or default risk in a scheme. Government securities do not have a credit risk. Similarly, cash and cash equivalents do not have a credit risk. Investments in corporate issuances carry accredit risk. Higher the credit rating, lower is the default risk.

8.5 Benchmarks and Performance

8.5.1 Benchmarks

Mutual fund schemes invest in the market for the benefit of Unit-holders. How well did a scheme perform this job? An approach to assess the performance is to pre-define a comparable – a benchmark – against which the scheme can be compared.

A credible benchmark should meet the following requirements:

- It should be in synch with the investment objective of the scheme i.e. the securities or variables that go into the calculation of the benchmark should be representative of the kind of portfolio implicit in the scheme's investment objective. This aspect is discussed in the next section.

- The benchmark should be calculated by an independent agency in a transparent manner, and published regularly. Most benchmarks are constructed by stock exchanges, credit rating agencies, securities research houses or financial publications.

Choice of benchmark is simplest for an index fund. The investment objective is clear on the index that the scheme would mirror. That index would then be the benchmark for the scheme.

For other schemes, choice of benchmark is subjective. The benchmark for a scheme is decided by the AMC in consultation with the trustees. Offer document of the scheme has to mention the benchmark. Further, along with the past performance of the scheme, the performance of the benchmark during the same period is to be mentioned.

At a later date, the fund may choose to change the benchmark. This could be for various reasons. For instance, the investment objective of the scheme may change, or the construction of the index may change, or a better index may become available in the market. AMCs can change the benchmark in consultation with the trustees. Further, the change needs to be justified and documented.

Some mutual fund research houses compare mutual fund schemes with a benchmark which is the average returns by all schemes in the category or the best performer in the category, i.e. the performance is benchmarked against the peer group. For example, the performance of a diversified equity fund is benchmarked against the average returns of all diversified equity funds in the market, or the best performer in the category.

8.5.2 Benchmarks for equity schemes

The following aspects of the investment objective drive the choice of benchmark in equity schemes:

Scheme Type

A sector fund would invest in only the concerned sector; while diversified funds invest in all sectors. Therefore, diversified funds need to have a diversified index, like S&P BSE Sensex or CNX Nifty or S&P BSE 200 or S&P BSE 500 or CNX 100 or CNX 500 as a benchmark; sectoral / thematic funds select sectoral / thematic indices like S&P BSE Bankex, S&P BSE FMCG Index, CNX Infrastructure Index and CNX Energy Index.

Choice of Investment Universe

Some diversified equity funds invest in large companies; then there are others that focus on mid-cap stocks. The definition of mid cap keeps varying depending on valuations in the market. Further, different agencies have different criteria for classifying a stock as mid cap. Indicatively, companies with market capitalization between Rs 1,500 crore to Rs 10,000 crore can be taken as mid cap stocks.

S&P BSE Sensex and CNX Nifty are calculated based on 30 (in the case of Sensex) / 50 (in the case of Nifty) large companies. Thus, these indices are appropriate benchmarks for diversified equity funds that invest in large companies. A diversified equity fund that has chosen mid-cap stocks as its investment universe, would find mid cap indices like CNX Midcap or Nifty Midcap 50 or S&P BSE Midcap to be better benchmarks.

Choice of Portfolio Concentration

Some diversified equity funds prefer to have fewer stocks in their portfolio. For such schemes, appropriate benchmarks are narrow indices like S&P BSE Sensex and CNX Nifty, which are calculated based on fewer stocks. Schemes that propose to invest in more number of companies will prefer broader indices like S&P BSE 100 / CNX 100 (based on 100 stocks), S&P BSE 200 / CNX 200 (based on 200 stocks) and S&P BSE 500 / CNX 500 (based on 500 stocks).

Underlying Exposure

Arbitrage funds invest in equities, but their underlying exposure is not to the equity market. The reason for this seemingly contradictory statement is that arbitrage funds take opposite positions in the cash and F&O markets. Apart from various technical factors, funding cost drives the spread between the two markets. Therefore, the benchmark for an arbitrage fund is generally a short term money market index, although these are categorized as equity schemes.

8.5.3 Benchmarks for Debt Schemes

As per SEBI guidelines, the benchmark for debt (and balanced schemes) should be developed by research and rating agencies recommended by AMFI.CRISIL, ICICI Securities and NSE have developed various such indices.

NSE's MIBOR (Mumbai Inter-Bank Offered Rate) is based on short term money market. NSE similarly has indices for the Government Securities Market. These are available for different variations such as Composite, 1-3 years, 3-8 years, 8+ years, Treasury Bills index etc.

ICICI Securities' Sovereign Bond Index (I-Bex) is again calculated based on government securities. It consists of an umbrella index covering the entire market, and sub-indices catering to three contiguous maturity buckets. The three sub-indices are:

- Si-Bex (1 to 3 years),
- Mi-Bex (3 to 7 years) and
- Li-Bex (more than 7 years)

CRISIL gives out the values of CRISIL Gilt Bond Index and the AAA Corporate Bond Index. Some of its other debt indices are:

- CRISIL CompBEX - Composite Bond Index
- CRISIL LiquiFEX - Liquid Fund Index
- CRISIL STBEX - Short-Term Bond Index
- CRISIL Debt Hybrid Index – 60:40
- CRISIL Debt Hybrid Index – 75:25

The following aspects of the investment objective drive the choice of benchmark in debt schemes:

Scheme Type

Liquid schemes invest in securities of less than 91 days maturity. Therefore, a short term money market benchmark like NSE's MIBOR or CRISIL LiquiFEX is suitable.

Non-liquid schemes can use one of the other indices mentioned above, depending on the nature of their portfolio.

Choice of Investment Universe

Gilt funds invest only in Government securities. Therefore, indices based on Government Securities are appropriate. Debt funds that invest in a wide range of Government and non-Government securities need to choose benchmarks that are calculated based on a diverse mix of debt securities. In the absence of a vibrant market for non-Government securities, related indices are not so widely available. CRISIL's AAA corporate bond index is one such non-government securities based index.

8.5.4 Benchmarks for Other Schemes

Hybrid Funds

These invest in a mix of debt and equity. Therefore a blend of an equity and debt index can be considered. For instance, a hybrid scheme with asset allocation of about 65% in equity and balance in debt, can use a synthetic index that is calculated as 65% of S&P BSE Sensex and 35% of I-Bex. CRISIL has also created some blended indices. CRISIL MIPEX is suitable for Monthly Income Plans; CRISIL BalanCEX can be considered by balanced funds.

However, it should be noted that, considering the prevailing tax laws, the balanced funds, in general maintain allocation of more than 65% of the NAV in equity shares. This helps them to maintain tax status as equity oriented funds with incidental tax benefits to investors.

Gold ETF

Gold price would be the benchmark for such funds.

Real Estate Funds

A few real estate services companies have developed real estate indices. These have shorter histories, and are yet to earn the wider acceptance that the equity indices enjoy.

International Funds

The benchmark would depend on where the scheme proposes to invest. Thus, a scheme seeking to invest in China might have the Chinese index, Hang Seng as a benchmark. S&P 500 may be appropriate for a scheme that would invest largely in the US market. A scheme that seeks to invest across a number of countries, can structure a synthetic index that would be a blend of the indices relevant to the countries where it proposes to invest.

- As discussed in Chapter 5, for the sake of standardization, schemes need to disclose return in INR and by way of CAGR for the following benchmarks apart from the scheme benchmarks:

Scheme Type	**Benchmark**
Equity scheme	Sensex or Nifty
Long term debt scheme	10 year dated GoI security
Short-term debt fund	1 year T-Bill

8.6 Quantitative Measures of Fund Manager Performance

8.6.1 Absolute & Relative Returns

In the section on calculation of returns, the focus was on absolute returns i.e. returns earned by the scheme. Having understood the concept of benchmarks, one can also do relative comparison viz. how did a scheme perform vis-à-vis its benchmark or peer group. Such comparisons are called *relative return* comparisons.

If a comparison of relative returns indicates that a scheme earned a higher return than the benchmark, then that would be indicative of *outperformance* by the fund manager. In the reverse case, the initial premise would be that the fund manager *under-performed.* Such premises of outperformance or under-performance need to be validated through deeper performance reviews.

AMCs and trustees are expected to conduct such periodic reviews of relative returns, as per SEBI Guidelines.

8.6.2 Risk-adjusted Returns

Relative returns comparison is one approach to evaluating the performance of the fund manager of a scheme. A weakness of this approach is that it does not differentiate between two schemes that have assumed different levels of risk in pursuit of the same investment objective. Therefore, although the two schemes share the benchmark, their risk levels are different. Evaluating performance, purely based on relative returns, may be unfair towards the fund manager who has taken lower risk but generated the same return as a peer.

An alternative approach to evaluating the performance of the fund manager is through the risk reward relationship. The underlying principle is that return ought to be commensurate with the risk taken. A fund manager, who has taken higher risk, ought to earn a better return to justify the risk taken. A fund manager who has earned a lower return may be able to justify it through the lower risk taken. Such evaluations are conducted through *Risk-adjusted Returns*.

There are various measures of risk-adjusted returns. This workbook focuses on three, which are more commonly used in the market.

Sharpe Ratio

An investor can invest with the government and earn a risk-free rate of return (R_f). T-Bill index is a good measure of this risk-free return.

Through investment in a scheme, a risk is taken, and a return earned (R_s).

The difference between the two returns i.e. $R_s - R_f$ is called *risk premium.* It is like a premium that the investor has earned for the risk taken, as compared to government's risk-free return.

This risk premium is to be compared with the risk taken. Sharpe Ratio uses Standard Deviation as a measure of risk. It is calculated as

$(R_s - R_f) \div$ Standard Deviation

Thus, if risk free return is 5%, and a scheme with standard deviation of 0.5 earned a return of 7%, its Sharpe Ratio would be (7% - 5%) ÷ 0.5 i.e. 4%.

Sharpe Ratio is effectively the risk premium per unit of risk. Higher the Sharpe Ratio, better the scheme is considered to be. Care should be taken to do Sharpe Ratio comparisons between comparable schemes. For example, Sharpe Ratio of an equity scheme is not to be compared with the Sharpe Ratio of a debt scheme.

Sharpe ratio is very commonly used measure of risk-adjusted returns.

Treynor Ratio

Like Sharpe Ratio, Treynor Ratio too is a risk premium per unit of risk.

Computation of risk premium is the same as was done for the Sharpe Ratio. However, for risk, Treynor Ratio uses Beta.

Treynor Ratio is thus calculated as:

(R_s minus R_f) ÷ Beta

Thus, if risk free return is 5%, and a scheme with Beta of 1.2 earned a return of 8%, its Treynor Ratio would be (8% - 5%) ÷ 1.2 i.e. 2.5%.

Higher the Treynor Ratio, better the scheme is considered to be. Since the concept of Beta is more relevant for diversified equity schemes, Treynor Ratio comparisons should ideally be restricted to such schemes.

Alpha

The Beta of the market, by definition is 1. An index scheme mirrors the index. Therefore, the index scheme too would have a Beta of 1, and it ought to earn the same return as the market. The difference between an index fund's return and the market return, as seen earlier, is the *tracking error*.

Non-index schemes too would have a level of return, which is in line with its higher or lower beta as compared to the market. Let us call this the *optimal return.*

The difference between a scheme's actual return and its optimal return is its *Alpha* – a measure of the fund manager's performance. Positive alpha is indicative of out-performance by the fund manager; negative alpha might indicate under-performance.

Since the concept of Beta is more relevant for diversified equity schemes, Alpha should ideally be evaluated only for such schemes.

These quantitative measures are based on historical performance, which may or may not be replicated.

Such quantitative measures are useful pointers. However, blind belief in these measures, without an understanding of the underlying factors, is dangerous. While the calculations are arithmetic – they can be done by a novice; scheme evaluation is an art - the job of an expert.

Tracking Error

Tracking error is a measure of the consistency of the out-performance of the fund manager relative to the benchmark. Earlier it was used as a measure of how closely an index fund tracked the returns from the benchmark to which it was indexed. The tracking error was expected to be zero. Now, the tracking error is used to measure how consistently a fund is able to out-perform its benchmark. It is not enough if the fund is able to generate a high excess return, it must do so consistently. Tracking error is calculated as the standard deviation of the excess returns generated by the fund. The tracking error has to be low for a consistently out-performing fund.

Sample Questions

1. **Fundamental analysis is evaluation of the strength of the company's price-volume charts.**

    a. True
    b. False

2. **In a top-down approach, sector allocation precedes stock selection.**

    a. True
    b. False

3. **Which of the following is a truly international asset class?**

    a. Real Estate
    b. Equity
    c. Debt
    d. Gold

4. **Loads and taxes may account for the difference between scheme returns and investor returns.**

    a. True
    b. False

5. **The most appropriate measure of returns for a scheme in existence for several years is _______.**

    a. Simple Return
    b. Dividend Return
    c. Annualised Return
    d. CAGR

6. **Risk can be measured by ______.**

    a. Variance
    b. Standard Deviation
    c. Beta
    d. Any of the above

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CHAPTER 9: SCHEME SELECTION

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Selecting different mutual funds scheme according to the scheme objective
- Sources of data for tracking performance of mutual fund schemes

The selection of a scheme for an investor will depend upon the need that the investor has from the investment. The investor may need long term appreciation in the value of his investment, or the investor may need periodic income from the investment, or the investor may be looking for an avenue to park funds and need an investment with high liquidity.

It is considered a good practice to first understand the risk exposure that is appropriate for an investor (through a risk profiler, which is discussed in Chapter12). Based on that, decide how the investor's investments should be distributed between different asset classes (asset allocation, which is discussed in Chapter 12).

Mutual funds are a vehicle that helps an investor take exposure to different asset classes, such as equity, debt, gold and real estate. The benefits of mutual funds and various kinds of schemes were discussed in Chapter 1. How does an investor select between the various schemes? Broadly, this flows from the asset allocation. Equity funds will help in equity exposure; gold funds will help in gold exposure etc.

As a structured approach, the sequence of decision making is as follows:

Step 1 – Deciding on the asset class such as equity, debt, gold and others, based on the investor's need for growth, income or liquidity

Step 2 – Selecting a scheme category based on strategy and style within the scheme type based on the risk-taking ability of the investor. For example, large-cap or mid-cap funds, diversified or focussed funds, short-term or long-term debt funds, each have different risk and return features.

Step 3 – Selecting a particular scheme from a category based on its performance.

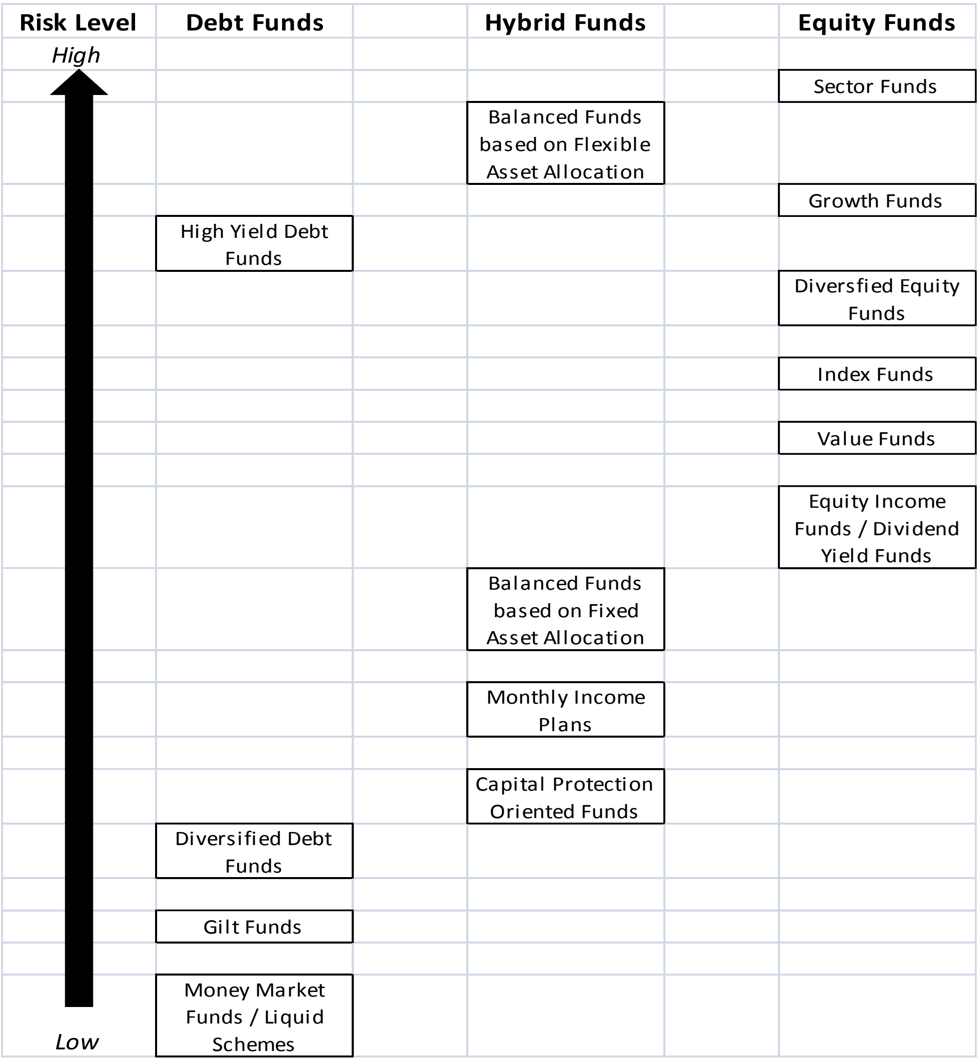
Step 4 – Selecting the right option within the scheme

9.1 How to choose between Scheme Categories?

The investor's need from the investment will determine the asset class that is the most suitable. An investor looking for growth will find equity the best suited to meet their needs. The need for income will be best by debt, an investor who wants regular income will look at a hybrid fund such as a Monthly Income Plan. Along with the need from the investment the investor's ability to take risk and the investor's investment horizon is equally important to select the appropriate asset class. An investor may be seeking growth and may be willing to take risk, but unless there is an adequately long investment horizon equity may not be suitable for investment. This is because equity markets tend to be volatile in the short-term. Over the long-term, the volatility gets smoothened out and the investments see an upward trend. An investor may have a long term investment horizon but may be unwilling to take the risks associated with equity investing. Such an investor may prefer the lower returns from debt than the higher returns with higher risk from equity.

The risk and return drivers for various categories of schemes was discussed in the previous unit. Risk levels, especially across categories, are subjective.

Yet, as a learning-aid, a pictorial representation of the risk hierarchy of different schemes follows:



At the next level, investors must select the product category based on the strategy and style adopted. Each of them have a different risk and return characteristics. An investor who wants to invest in low risk equity will consider an index fund or a value fund. On the other hand, an investor willing to take additional risk for better returns will choose a growth fund. An investor in debt who wants better returns will consider an Income fund or a long-term gilt fund, if they have a view that interest rates will decline.

At this stage it is also good to consider the role that the scheme will play in the investor's portfolio. Ideally the portfolio should be divided into core and satellite portfolios. The core portfolio will be invested according to the long term needs and goals of the investor. The satellite portfolio will be invested to take advantage of expected short-term market movements. For example, a diversified equity fund, short-term debt fund, Income fund, Monthly Income Plans. Balanced funds, among others, form part of the core portfolio since they generate long-term returns in broad alignment with the markets. Sector funds on the other hand do well cyclically, and investors will consider investing in them when the economic factors are positive for a particular sector. Similarly, long term gilt funds will do well when interest rates are expected to decline. The exposure to gold funds can be increased when inflation is high or there is political, economic and fiscal uncertainties. These are all tactical investments and are held for the period when the conditions are suitable. The division between core and satellite portfolios will depend upon each investor's profile. Conservative investors may like a very small proportion of their overall portfolio to be managed tactically. A moderate investor may be comfortable with an 80% allocation to core investments and a 20% exposure to satellite or tactical portfolio. An investor comfortable with taking higher risk may have an even higher exposure to tactical investments.

The different types of funds are described below:

9.1.1 Equity Funds

While investing in equity funds, a principle to internalize is that markets are more predictable in the long term, than in the short term. So, it is better to consider equity funds, when the investment horizon is adequately long.

The choices available to the investor in equity scheme categories and the features that have to be evaluated are as follows:

Active or Passive

As seen in Chapter1, index funds are passive funds. They are expected to offer a return in line with the market because they invest in a portfolio that mimics a market index in the securities it invests in and in the weightages allotted to each security in the portfolio. There is no selection risk in index funds because the fund manager has no role in creating the portfolio. For this reason the costs that an index fund is allowed to charge is also lower since there are no research or other fund management expenses. Exchange traded funds (ETF) are also passive funds that generate returns in line with the index or benchmark. There are no investment strategies used to generate higher returns. Passive funds are suitable for investors looking for exposure to an asset class without the risks associated with fund manager selection and strategies.

An investor in an active fund is bearing a higher cost for the fund management, and a higher risk to earn returns better than the benchmark. The returns ought to be higher i.e. the scheme should beat the benchmark, to make the investor believe that choice of active scheme was right. This, in no way, means that the higher return that ought to happen, will happen. Hence, the quantum of risk is higher in such investments.

Investors who are more interested in the more modest objective of having an equity growth component in their portfolio, rather than the more aggressive objective of beating the equity market benchmark, would be better off investing in an index fund. This again does not mean that the NAV of an index fund will not decline in value. If the bench mark index goes down, then the NAV of the index fund too will go down. However, as suggested earlier, if the investor has a long enough horizon, then his investment will do well, in line with the overall market.

Several pension funds are limited by their charter, to take equity exposures only through index funds.

Open-ended or Close-ended

The significant benefit that open-ended funds offer is liquidity viz. the option of getting back the current value of the unit-holding from the scheme.

A close-ended scheme offers liquidity through a listing in a stock exchange. Unfortunately, mutual fund units are not that actively traded in the market. A holder of units in a close-ended scheme will need a counter-party in the stock exchange in order to be able to sell his units and recover its value.

The price of units of a closed-end scheme in the stock exchange may be lower than the NAV. There is no limit to this discount. Typically, towards the maturity of the scheme, the market price converges towards the NAV. A closed-ended equity fund allows the fund manager to target better returns by investing in stocks of companies that may realize its potential in some time, or in relatively illiquid stocks with prospects of good returns without the pressure of investor redemptions. Investors may invest in such schemes for the higher returns that such a strategy may provide. However, they do not have the facility of exiting the scheme if they find that the scheme’s performance is not as expected. Moreover, investors need to match the maturity of the scheme with when they may require the funds invested since exiting prior to maturity by selling on the stock exchange is not a viable option.

In the case of an open-ended scheme, the unit will be bought back by the scheme at the NAV less exit Load. SEBI legislations prescribe a maximum exit load of 7%; in practice, it was rarely above 5%, which too was applicable only if investors exited from the scheme within a year of investment. Whatever the exit load percentage, it is known when the investor makes his investment in the scheme.

In order to provide this liquidity facility to investors, open-ended schemes maintain a part of their portfolio in liquid assets. The liquid assets component in the portfolio of an equity fund can dilute the returns that would otherwise have been earned in the equity market.

Open-end schemes are also subject to the risk of large fluctuations in net assets, on account of heavy sales or re-purchases. This can put pressure on the fund manager in maintaining the investment portfolio.

Diversified, Sector or Thematic

The critical difference between the two is that the multi-sector exposure in a diversified fund makes it less risky. Further, in an actively managed diversified fund, the fund manager performs the role of ensuring higher exposure to the better performing sectors.

Funds that are diversified across sectors or industries and market segments such as large, mid and small cap, makes such schemes suitable for a core portfolio investment. Some diversified schemes may be diversified across sectors but may include only large-cap stocks. This makes them suitable for low-risk investors who want some equity exposure in their portfolio.

Sector funds are risky because of the concentration in one sector. If the sector under-performs then the scheme's returns is likely to be poor. Such funds require the investor to have the skill to understand and interpret the factors that signal that a sector is ready for investment or exit. The returns earned will depend upon entering before the upcycle in the sector starts and exiting before the downturn begins. Timing is the key to investing in such funds. The higher risk, monitoring and timing involved in such funds make them suitable for the satellite portfolio of the investor.

Some investors are more comfortable identifying promising investment themes (for example, infrastructure), rather than specific sectors (like cement, steel etc.). Such investors can decide on investment themes they would like to buy.

Large-cap v/s Mid-cap / Small Cap Funds

Large-cap stocks are of established companies that have stable revenues and profitability and the financial strength to withstand competition and economic downturn. Unlike such companies, mid and small caps represent companies that are in the initial stages of growth. When the economy is doing well, such companies see a tremendous growth in revenues and profitability, making them extremely attractive investment options. When industry scenario is difficult many mid-cap / small cap companies fall by the way side during economic turmoil, because they lack the resources to survive. As the economy recovers, and investors start investing in the market, the valuations in front-line stocks turn expensive. At this stage, the mid-cap / small cap funds offer attractive investment opportunities. Over a long period of time, some of the mid-cap and small-cap companies will become large companies, whose stocks get re-rated in the market. The healthy returns on such stocks can boost the returns on mid-cap and small-cap portfolios.

Mid and small cap stocks require careful evaluation and selection. It can therefore be risky to invest a large portion of the investor's portfolio in mid-cap / small cap funds.

Growth or Value funds

Funds that follow the growth strategy seek to identify companies that are expected to grow at rates higher than the average economic growth rate. Stocks of such companies tend to do well in a bull phase in the markets. But in a market downturn the price of such stocks tend to fall much more too, making them riskier. Value strategy seeks to identify stocks that are available at a price that is seen as cheap relative to the value that could be unlocked in the future. Since these stocks are seen as being out of favour in the market, the extent of fall in their value in a downturn is limited. Over time, if the fund has been able to select the right stocks and the stock is recognized in the market, the values appreciate. A growth fund outperforms in a bull market, while the value orientations helps a value fund outperform in a falling market. Depending on the risk-profile of the investor, both these type of funds can find a place in the core portfolio of the investor in suitable proportions. Investments in value funds yield benefits over longer holding periods.

Arbitrage funds

These are not meant for equity risk exposure, but to lock into a better risk-return relationship than liquid funds – and ride on the tax benefits that equity schemes offer.

International Equity funds

When an Indian investor invests in equities abroad, he is essentially taking two exposures:

- An exposure on the international equity market
- An exposure to the exchange rate of the rupee. If the investor invests in the US, and the US Dollar becomes stronger during the period of his investment, he benefits; if the US Dollar weakens (i.e. Rupee becomes stronger), he loses or the portfolio returns will be lower.

Investors might consider investing abroad, for any of the following reasons:

- He feels that the overall returns (international equity + exchange rate movement)will be attractive
- He is taking an asset allocation call of diversifying his investments to reduce the risk.

- Such schemes provide a way to benefit from a particular opportunity and therefore are best suited to be part of the satellite portfolio of the investor, or a very small exposure in the core portfolio to benefit from the diversification benefits.

9.1.2 Debt Funds

Debts funds are less risky than equity funds for the reasons discussed in the previous unit. These can be structured in various ways to meet useful investor needs. Some of these structures, and their benefits to investors were discussed in Chapter1. The risks in these structures, as discussed in the previous chapter, need to be understood.

Monthly Income Plans (MIPs)

MIP has an element of equity in its portfolio to give a boost to the fund's return. Even if the investor is not looking for a regular monthly income, such funds can be a convenient way to get some equity exposure. Before considering the MIP evaluate the portfolio to see the extent of equity exposure the fund takes. This can typically range from 5% to 30%. Investors should also evaluate bow the equity portion of the fund is managed i.e whether the fund invests in large, mid or small cap stocks, if the stocks represent diverse sectors and so on. Based on this the investor can decide on the suitability of the investment.

Fixed Maturity Plans (FMPs)

FMP is ideal when the investor's investment horizon is in synch with the maturity of the scheme, and the investor is looking for a more predictable return than conventional debt schemes, and a return that is generally superior to what is available in a fixed deposit. The portfolio risk discussed in the previous Chapter needs to be considered too.

An investor, who is likely to require the funds anytime, would be better off investing in a normal open-ended debt fund.

Diversified Debt Funds

Diversified debt funds or income funds invest in a mix of government securities (which are safer with respect to the risk of default) and non-government securities (which offer higher yields, but are subject to credit risk). A diversified mutual fund debt scheme can generate superior returns. The fund manager can take greater exposure to Gilts to benefit from capital gains when interest rates are expected to reduce. The fund can alter the portfolio to benefit from opportunities in the yield spread and credit spreads. An income fund can be a part of the core portfolio of investors.

Short Term Debt Fund

Short-term debt funds invest in securities with maturities of less than on year. As such they earn returns in line with the market yields. Some funds may take a small exposure to longer term securities to benefit from a gain in value if interest rates are expected to decline.

If it is expected that interest rates in the market would go up, it would be safer to go with Short Term Debt Funds. As the rates rise, the short-term bonds would mature, allowing the fund manager to deploy the proceeds at higher rates. Funds need to be evaluated for the extent of exposure, if any, they would take in long term debt securities which would increase the volatility in the returns and the credit risk that they may take that would increase the default risk in the fund. These funds feature low volatility and can form part of the core portfolio of an investor with low risk taking ability. The liquidity in the schemes make them suitable for parking funds for the short-term.

Money Market Funds / Liquid Schemes

An investor seeking the lowest risk ought to go for a liquid scheme. However, the returns in such instruments are low. The comparable for a liquid scheme in the case of retail investors is a savings bank account. These schemes are suitable for investors looking for a product to park their funds for very short periods. The schemes are highly liquid and there is negligible volatility, which protects the value of the money parked. Using these schemes for longer periods is not advised since the investor will be needlessly losing out on returns.

Ultra-short term debt funds hold securities with slightly longer tenor than liquid funds, but paly the same role in an investor’s portfolio. The feature low volatility and high liquidity.

Floating Rate Funds

Regular debt funds are subject to the risk of fluctuations in NAV. Since floating rate debt securities tend to hold their values, even if interest rates fluctuate, the NAV of floaters tend to be steady.

9.1.3 Hybrid Schemes

The discussion on asset allocation brought out the benefit of diversifying the investment portfolio across asset classes. An investor desirous of having a mix of debt and equity exposures has two options –

- He can invest in a mix of equity schemes and debt schemes
- He can invest in a balanced scheme, which in turn invests in a mix of equity and debt securities.

The first option obviously implies more decisions on scheme selection that the investor would need to take. But the benefit is that the investor has a wide array of scheme options, within both equity and debt scheme categories. Further, the investor would be in a position to work towards a mix of debt and equity that is most appropriate for him.

Investing in a balanced scheme makes things simpler for the investor, because fewer scheme selection decisions need to be taken. However, the investor would need to go by the debt-equity mix in the investment portfolio of the schemes.

The equity component in an equity-oriented hybrid fund provides the appreciation in value, while the regular returns from the debt component provides the stability to the returns. Such funds are suitable for investors who want equity exposure but with lower risk. Evaluate the type and extent of equity exposure that the fund takes as a norm to assess the risk in the fund.

Investors need to be cautious of the high risk potential of a variant of balanced schemes that are structured as flexible asset allocation schemes.

Further, balanced schemes may be taxed as a debt scheme or an equity scheme depending on the scheme's investment portfolio. The two categories of schemes have completely different tax implications, as was discussed in Chapter 6.

9.1.4 Gold Funds

Investors need to differentiate between Gold ETF and Gold Sector Funds. The latter are schemes that invest in shares of gold mining and other gold processing companies. The performance of these gold sector funds is linked to the profitability of these gold companies – unlike Gold ETFs whose performance would track the price of gold. When gold metal prices go up, gold mining companies with large reserves of gold can appreciate a lot more than the gold metal. Conversely, they can also fall more when gold metal prices decline. The prices of shares gold mining and other such companies will be also driven by factors other than purely the price of gold. For example, if there are concerns about a company's management the share prices may see a decline irrespective of the price of gold. On the other hand, ETF NAVs closely track the price of gold since it reflects the value of gold held in custody for the units issued. It makes it a more efficient way to take exposure to gold.

Investors therefore need to understand the structure of the gold schemes more closely, before investing.

9.1.5 Other Funds

As per mutual fund regulations, debt, equity, gold and real estate are the only asset classes permitted for investment. More categories might come up in future. Or some foreign schemes with other asset class exposures might be permitted. The discussion in the previous unit on risks in gold and real estate funds are a useful primer on the kinds of issues to explore in any new category of mutual fund schemes.

9.2 How to select a Scheme within a Scheme Category?

All the 45 AMCs that are permitted to do business in India, meet the minimum eligibility criteria set by law. Different AMCs have different approaches, styles and value systems in doing business. An investor has to be comfortable with the AMC, before investing in any of its schemes.

An investor buying into a scheme is essentially buying into its portfolio. Most AMCs share the portfolio of all their schemes in their website on a monthly basis.

Investors would like to evaluate whether the fund's portfolio reflects its investment objective, and that the fund managers follow the strategy and style that the scheme intends to follow according to its offer document.

Experienced researchers can also identify how true the fund manager is, to the promised investment style. A large proportion of fully-valued front-line stocks in the portfolio of a value fund is indicative of the fund manager not being true to the promised investment style. A short-term debt fund that takes significant exposure to long-term debt instruments to generate better returns may be taking on more risk than what the investors are comfortable with. An MIP that takes aggressive equity positions for better returns may be exposing the investors to higher risk that what they signed up for.

Investors in non-gilt debt schemes will keep an eye on credit quality of the portfolio – and watch out for sector concentration in the portfolio, even if the securities have a high credit rating.

Long-term watchers of mutual fund performance also develop views on AMCs/ Fund Managers that are more prescient in identifying changes in market trends.

Some other parameters that are considered while selecting schemes within a category, are as follows:

Fund Performance

The fund's performance is a primary criterion in its selection from amongst other schemes. The returns that the fund has generated relative to its benchmark is evaluated over a period of time. The fund should ideally have consistently outperformed the benchmark. Not only should it have over-performed in a bull market, but in a falling market it should have been able to protect the downside. In case of equity funds, the performance should be seen for longer periods, at least last 5 years. While for long-term debt funds at least 3 years performance need to be considered, for short-term debts funds, shorter performance periods is suitable. The fund's performance against the peer group should also be considered to make the right selection.

Fund Portfolio

The fund's portfolio has to be evaluated to determine the risk and return in the scheme. In case of equity funds, the level of diversification across sector and stocks, the market segment in which the fund invests, the extent of cash held and the conviction showed in terms of the length of holding in stocks and churn in the portfolio, have to be considered. In case of debt funds, the average maturity and duration of the portfolio, the credit risk profile, the contribution of interest and capital gains to the total returns of the fund, liquid holding in the portfolio, need to be evaluated before making an investment decision.

Fund Age

A fund with a long history has a track record that can be studied. A new fund managed by a portfolio manager with a lacklustre track-record is definitely avoidable. A new fund that offers a new investment opportunity should be evaluated for its suitability.

Fund age is especially important for equity schemes, where there are more investment options, and divergence in performance of schemes within the same category tends to be more.

Fund Size

The size of funds needs to be seen in the context of the proposed investment universe. For an equity fund that intends to invest in large cap stocks, a large fund size will be an advantage, while for a sector fund or a mid-cap fund with limited investment options a large fund size may be a disadvantage. A large fund size will allow better diversification and economies of scale. A small sized fund on the other hand is more flexible and better able to take advantage of market opportunities.

Portfolio Turnover

Purchase and sale of securities entails broking costs for the scheme. Frequent churning of the portfolio would not only add to the broking costs, but also be indicative of unsteady investment management.

Portfolio Turnover Ratio is calculated as Value of Purchase and Sale of Securities during a period divided by the average size of net assets of the scheme during the period. Thus, if the sale and purchase transactions amounted to Rs 10,000 crore, and the average size of net assets is Rs 5,000 crore, then the portfolio turnover ratio is Rs 10,000 cr ÷ Rs 5,000 cr i.e. 200%. This means that investments are held in the portfolio, on an average for 12 months ÷ 2 i.e. 6 months.

The portfolio turnover needs to be viewed in the light of the investment style. 6 month holding period may be too short for a value investment style, but perfectly acceptable for a scheme that wants to benefit from shifts in momentum in pivotal. A short holding period may indicate that the fund manager is looking for tactical investments to take advantage of short term market opportunities rather than identifying and investing in fundamentally strong companies for the long-term.

Scheme running expenses

Any cost is a drag on investor's returns. Investors need to be particularly careful about the cost structure of debt schemes, because in the normal course, debt returns can be much lower than equity schemes. Similarly, since index funds follow a passive investment strategy, a high cost structure is questionable in such schemes.

Risk, return and risk-adjusted returns as parameters to evaluate schemes were discussed in the previous unit. These form the basis for mutual fund research agencies to assign a rank to the performance of each scheme within a scheme category (ranking). Some of these analyses cluster the schemes within a category into groups, based on well-defined performance traits (rating).

Every agency has its distinctive methodology for ranking / rating, which are detailed in their websites. Investors should understand the broad parameters, before taking decisions based on the ranking / rating of any agency.

Some research agencies follow a star system for the rating. Thus, a 5-star scheme is better than a 4-star scheme; 4-star scheme is better than 3-star, and so on and so forth.

Quarterly performance ranking of schemes over a period of time shows that the best ranking fund in a quarter is not necessarily the best ranking fund in the next quarter. Therefore, seeking to be invested in the best fund in every category in every quarter is neither an ideal objective, nor a feasible target proposition. Indeed, the costs associated with switching between schemes are likely to severely impact the investors' returns.

The investor should therefore aim to stay invested in schemes that are in the top "few" in their category on a consistent basis. The "few" could mean 3 to 5, in categories that have few schemes; or the top 10-15%, in categories where there are more schemes. Investors need to bear in mind that these rankings and categories are based on historical performance, which may or may not be repeated in future.

The investor also needs to remember that beyond performance of the scheme, loads make a difference to the investor's return.

9.3 Which is the Better Option within a Scheme?

The underlying returns in a scheme, arising out of its portfolio and cost economics, is what is available for investors in its various options viz. Dividend payout, dividend re-investment and growth options.

Dividend payout option has the benefit of money flow to the investor; growth option has the benefit of letting the money grow in the fund on gross basis (i.e. without annual taxation). Dividend re-investment option neither gives the cash flows nor allows the money to grow in the fund on gross basis.

Re-purchase transactions are treated as a sale of units by the investor. Therefore, there can be an element of capital gain (or capital loss), if the re-purchase price is higher (or lower) than the cost of acquiring those units. Some investors may like to book such a capital gain (or capital loss) to set it off against some other capital loss (or capital gain), where such set off is permitted. The broad set-off rules, including the differential treatment of long term and short term, were discussed in Chapter 6.

Re-purchase transactions in equity schemes are subject to STT. Further, there is no dividend distribution tax on equity schemes. Therefore, subject to the set-off benefit that some investors might seek, it is better to receive moneys in an equity scheme in the form of dividend, rather than re-purchase of units.

The dividend payout option seems attractive for investors wanting a regular income. It should however be kept in mind that even in a Monthly Income Plan, dividend declaration is a function of distributable surplus. If there is no surplus to distribute, dividend cannot be declared. Therefore, the investor is not assured of dividend in the monthly income plan. It is for this reason, that the need for regular income is better met through a SWP for the requisite amount. {Sale of units under an SWP may have STT implication (equity schemes) and capital gains tax implication (equity and debt schemes)}.

Dividend flows in a debt scheme come with the associated dividend distribution tax, which reduces the NAV. Thus, the investor is effectively bearing the cost of the dividend distribution tax, although it might be paid by the scheme to the income tax authorities. This cost might be fine for an investor in the high tax bracket, because the impact of the distribution tax could be lower than his marginal rate of taxation (which comes into play for taxation, if the investment is held for less than a year). But for a pensioner with no taxable income, or whose marginal rate of taxation is lower, it is meaningless to bear the cost of distribution tax. Thus, for such an investor, dividend option is not preferable. As seen earlier, SWP can take care of any need for a regular income – and there is no dividend distribution tax on the repurchase proceeds. The capital gains tax impact however, would need to be checked.

Thus, taxation and liquidity needs are a factor in deciding between the options. The advisor needs to understand the investor's situation before advising.

9.4 Sources of Data to track Mutual Fund Performance

It would now be evident to the reader, that mutual fund performance reviews are data intensive. An investor seeking to do the research by collecting daily NAV and dividend declaration information from the newspapers can find it frustratingly time consuming.

Fortunately, ready-made solutions are available in the market. Many AMCs, distribution houses and mutual fund research houses offer free tools in their website. Using these, the performance of schemes, their ranking, rating etc. and comparison of performance between specific schemes, is easy to ascertain.

Investors, who wish to access the raw data of NAVs, dividends etc. in a systematic manner – and distributors who wish to integrate such information into their investor-management systems and processes – can subscribe to the data from these vendors. Based on the subscription, data updates can be easily downloaded every day through the internet.

The mix of free and paid content is subject to change. The following are some of the agencies that are active in this field:

- Credence Analytics (www.credenceanalytics.com)
- CRISIL (www.crisil.com)
- Lipper (www.lipperweb.com)
- Morning Star (www.morningstar.com)
- Value Research (www.valueresearchonline.com)

The listing of websites is only a piece of information for the reader. Users need to convince themselves before subscribing to, or using any of this information. Neither SEBI nor NISM nor the author certifies the data or information or tools that these agencies offer.

The fund factsheets are an official source of information of the fund's objective, performance, portfolio and basic investment requirements issued by the fund house each month. The factsheet is also used by the fund manager to communicate their views on the economy and the markets to the investors and other observers such as research analysts, rating agencies and media. It is not mandatory for fund houses to publish factsheets. But most fund houses do so as a way to reach out to the existing and new investors.

The information disclosed in the factsheets are subject to the advertising guidelines of SEBI. The fund factsheet contains the basic information of each scheme such as the inception date, corpus size, current NAV, benchmark and a pictoral depiction of the fund's style of managing the fund. The fund's performance relative to the benchmark is provided for the different periods along with the benchmark returns, as required by SEBI's regulations. The factsheet may also provide the SIP returns in the scheme. The portfolio allocation to different sectors and securities are provided. Some funds may not disclose the entire portfolio but only the top 10 holdings. Portfolio features such as PE and Beta and other risk measures such as standard deviation and Sharpe ratio in case of equity funds and credit rating profile, average maturity and duration in case of debt funds are also available in the factsheet. The factsheet will also provide investment details such as the minimum investment amount, the plans and options available in the scheme, the loads and expenses and systematic transaction facilities available in the fund.

Sample Questions

1. **Equity markets are more predictable in the long term than the short.**

    a. True
    b. False

2. **Arbitrage funds are meant to give better equity risk exposure.**

    a. True
    b. False

3. **The comparable for a liquid scheme is _______.**

    a. Equity scheme
    b. Balanced Scheme
    c. Gilt Fund
    d. Savings Bank account

4. **Which of the following aspects of portfolio would an investor in a debt scheme give most importance?**

    a. Sector selection
    b. Stock selection
    c. Weighted Average Maturity
    d. Number of securities in portfolio

5. **Mutual fund ranking and rating amount to the same.**

    a. True
    b. **False**

CHAPTER 10: SELECTING THE RIGHT INVESTMENT PRODUCTS FOR INVESTORS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Difference between financial and physical assets
- Difference between fixed deposits and debt scheme
- Salient features of National Pension System

10.1 Financial and Physical Assets

10.1.1 The Concept

An investor who buys land, building, a painting or gold can touch and feel them. The investor can choose to build a house in the land, stay in the building, display the painting and make jewellery out of the gold. Such assets are called *physical assets*. Similarly, a company buying plant and machinery is buying physical assets. Physical assets have value and can be touched, felt and used.

An investor who buys shares in a company is entitled to the benefits of the shareholding – but this entitlement cannot be touched or felt. The paper on which the share certificate is printed can be touched and felt, but that paper is only evidence supporting the benefit that the investor is entitled to. The benefit itself is intangible. Such assets are called *financial assets*. Financial assets have value, but cannot be touched, felt or used as part of their core value.

Shares, debentures, fixed deposits, bank accounts and mutual fund schemes are all examples of financial assets that investors normally invest in. Their value is not in the paper or receipt on which they are printed, but in what they are entitled to viz. a share in the fortunes of the company (share), an amount repayable on a future date (debenture or fixed deposit), an amount that you can withdraw any time (bank account) or a share in the fortunes of a portfolio (mutual fund scheme).

It should be noted, even at the cost of repetition, that investing in a mutual fund scheme is different from investing directly in securities. A mutual fund is a vehicle to access these very securities. The returns generated by the securities are passed onto the mutual fund's unit holders, and thus, there may not be any guarantee of returns or capital when one invests in mutual fund schemes (unless it is a capital protected scheme, which was discussed in Chapter 1).

10.1.2 The Implication

Comfort

Investment in physical assets is a direct holding of the asset. Financial assets is an indirect holding of the rights to the earnings from specified assets. The investor in a physical asset draws psychological comfort from the fact that the asset is in the investor's possession, or under the investor's control in a locker. Whatever may happen in the outside world, the investor can still use the physical asset.

The value encashment in a financial asset, on the other hand, can depend on the investee company. What if the company closes down? What if the bank or mutual fund scheme goes bust? These are issues, whether fact or myths, that bother investors.

The difference in comfort is perhaps a reason why more than half the wealth of Indians is locked in physical assets.

Mutual fund schemes can offer a lot of comfort, in this regard, as was discussed in Chapter 3.

Unforeseen Events

The comfort of investors in physical assets is tempered by an understanding of consequences of unforeseen events. A physical asset is completely gone, or loses substantial value, when stolen, or if there is a fire, flood or such other hazard. It is for this reason that some owners of physical assets insure them against such hazards.

Theft or fire or flood, have no impact on the entitlement of the investor to a financial asset. The investor can always go the investee organization i.e. company or bank or mutual fund where the money is invested, and claim the entitlement, based on records of the investee company and other documentary evidence. Dematerialisation makes these processes a lot simpler.

Economic Context

Investor's money in land, art, rare coins or gold does not benefit the economy. On the other hand, money invested in financial assets, e.g. equity shares, debentures, bank deposits can be productive for the economy.

The money that the government mobilizes through issue of government securities can go towards various productive purposes.

The company, whose shares are bought, can invest the money in a project, which can boost production, jobs and national income.

The bank where the bank account or fixed deposit is maintained can lend the money to such productive activities, and thus help the economy.

Similarly, mutual fund schemes that invest in securities issued by companies are effectively assisting in building the nation and the economy.

This explains the interest of the government in converting more and more of the physical assets held by investors, into financial assets. Recognising that comfort is a key factor that can boost the conversion, a lot of importance is given to the regulation of the banks and financial markets. Independent regulators like RBI and SEBI therefore focus on creating the requisite policy framework, and ensuring that participants in the market adhere to the policy.

Liquidity

It is easier to liquidate financial assets as compared to most physical assets. Most financial assets provide some facility for realizing the funds when required. This may be through selling in the stock markets, or repurchase by the issuer, or premature withdrawals. There may be some penalty or cost associated with it. In case of physical assets, while selling is possible, it may be a longer and more cumbersome process. Some physical assets like gold can be easily sold, while others like real estate or art, may take a long time to realize its fair value. Moreover, in the case of financial assets it is easier to liquidate only a portion of the holding. In case of many physical assets, it may be necessary to dispose of the whole asset even if the amount required is much less. Both physical and financial assets can be used as security to take a loan against the assets. There is a process and cost associated with it.

Maintenance

Maintenance of physical assets involve time, effort and cost. Insurance, annual maintenance costs, taxes all add to the costs of maintaining the asset. In case of financial asset, the recurring costs of holding it are minimal, such as the annual demat account fees. Nomination is a facility offered by financial assets to ease the process of transmission of the assets to people entitled to receive it in the event of the death of the holder of the assets. In case of physical assets it is a complicated legal process to establish the right to the assets.

Gold and real estate are two physical assets, where a significant portion of investor wealth is blocked. The risk and return drivers for these asset classes was discussed in Chapter8. Let us now understand them in the context of format of holding - physical or financial.

10.2 Gold – Physical or Financial?

Gold suffers one of the highest risks of loss through theft. Storage in bank lockers too costs money. The exposure to gold as a financial asset can be taken in different forms:

- Gold ETF was discussed in Chapters 1 and 8.
- Gold Sector Fund was discussed in Chapters 1 and 8.

- Gold futures contracts are traded in commodity exchanges like the National Commodities Exchange (NCDEX). The value of these contracts goes up or down in line with increases or decreases in gold prices.

When an investor buys a gold futures contract, the entire value of the contract does not need to be paid. Only a percentage of the contract value (margin) is to be paid immediately. Investors can therefore take positions that are a multiple of what is otherwise possible with the money at hand. This practice of taking larger positions based on margin payments is called *leveraging.*

Let us consider an example.

Suppose gold can be bought at Rs 1,500 per gram. Purchase of 10 grams would cost Rs 15,000.

If it were possible to buy a gold futures contract at Rs 15,000 for 10 grams, the exchange would ask for a margin of, say, 5%. Initial margin payable would be Rs 15,000 X 5% i.e. Rs 750.

Thus, with an initial outlay of merely Rs 750, the investor is able to take a position worth Rs 15,000 in gold. Extending the logic further, if the investor had Rs 15,000 to invest in gold futures, he can take a position worth Rs 15,000 ÷ 5% i.e. Rs 300,000.

(It may be noted that exchanges have their contract specifications, which set the minimum contract size).

Investors need to be cautious of the risks associated with leveraging. In the above example, the investor took a position of Rs 300,000, based on investment of Rs 15,000 in gold futures. A 10% decline in gold price would translate into a loss of Rs 30,000. The investor needs to look at his ability to bear that loss – not merely consider how much exposure can be taken with the initial investment.

Further, gold futures contracts have a limited contract period. Thus, a 3-month gold futures contract will expire at the end of 3 months. An investor who wishes to continue his exposure will therefore need to roll over the position – effectively, enter into a fresh contract. Every contract purchase has its associated costs.

Gold ETF on the other hand is an open-ended scheme with no fixed maturity. It is very rare for an open-ended scheme to liquidate itself early. Therefore, an investor who buys into a gold ETF can hold the position indefinitely.

Gold deposit schemes are offered by some banks. This is like a fixed deposit in gold. An investor depositing gold into a Gold deposit scheme is given a receipt promising to pay back the same quantity of gold (or its equivalent value) on maturity. During the period of deposit, interest is paid at regular intervals, as in the case of a regular fixed deposit, but calculated as a pre-specified percentage on the value of the gold deposited.

An investor contemplating whether to invest in gold in physical form or financial, needs to note that:

- Wealth Tax is applicable on gold holding (beyond the jewellery meant for personal use). However, mutual fund schemes (gold linked or otherwise) and gold deposit schemes are exempted from Wealth Tax.
- Mutual fund schemes and deposit schemes offer the facility of appointing nominees who will be entitled to the proceeds in the event of death of the depositor / investor. Gold in physical form does not offer this facility.

10.3 Real Estate – Physical or Financial?

Besides the risk of loss on account of fire and other hazards, real estate in physical form is prone to a few more disadvantages:

- The ticket size i.e. the minimum amount required for investing in real estate is high. The investment would run into lakhs of rupees, even to buy agricultural land.

- Unless the budget is very high, and the value of properties bought are very low, investors would find it difficult to maintain a diverse portfolio of real estate. Thus, they end up with concentration risk.

- Once purchased, vacant land can be encroached upon by others. Therefore, unless properly guarded and secured, one can lose control and ownership of real estate, especially vacant land. The risk of encroachment is the highest for investment in land.

- Real estate is an illiquid market. Investment in financial assets as well as gold can be converted into money quickly and conveniently within a few days at a transparent price. Since real estate is not a standardized product, there is no transparent price – and deals can take a long time to execute.

- Once a deal is executed, the transaction costs, such as stamp duty and registration charges, are also high. At times, these regulatory processes are also non-transparent and cumbersome.

- When property is let out, there is a risk that the lessee may lay his own claim to the property (ownership risk) or be unable to pay the rent (credit risk).

It is for these reasons that real estate investors prefer to invest through Real estate mutual funds. The ticket sizes are flexible; further professional managers of the real estate portfolio are in a better position to manage the other risks and issues associated with real estate investment.

10.4 Using Mutual Funds to Meet Investor Goals

10.4.1 Debt Schemes for Fixed Income Investments

Several investors are comfortable only in placing money in bank deposits; they do not invest in debt schemes, partly because of lack of awareness. The following are features where bank deposits clearly score over mutual funds:

- In the event that a bank fails, the deposit insurance scheme of the government comes to the rescue of small depositors. Upto Rs. 1 lakh per depositor in a bank (across branches) will be paid by the insurer. This limit is inclusive of principal and interest. Mutual fund schemes do not offer any such insurance.
- The depositor can also prematurely close the deposit at any time, in order to meet liquidity requirements. However, a penalty needs to be borne for such premature closure.
- Mutual fund debt schemes are superior to bank deposits in the following respects:
    - With a bank deposit, the depositor can never earn a return higher than the interest rate promised. In a mutual fund scheme, no return is guaranteed – however it is possible to earn market returns. Fund managers manage the portfolio to generate the best returns possible given the market conditions. Different debt schemes have different objectives that can be aligned to the investor's needs. A risk averse investor who has a fixed investment horizon can invest in an FMP for better returns relative to a fixed deposits. A liquid fund or ultra-short term scheme can be a better option than a savings bank account to park funds. Short-term debt funds are suitable for investors looking to safely invest funds in bank fixed deposits. It gives better market-linked returns along with liquidity. Income funds and dynamic bond funds are suitable for investor seeking better returns for higher risk by investing in corporate fixed deposits. They offer better returns and higher liquidity.
    - Active investors can use debt funds to earn returns on their debt portfolio when interest rates are rising and falling. Short-term debt funds help earn higher interest income in a rising interest rate scenario. Long term debt funds help investors earn higher returns from capital gains in falling interest rate scenario.
    - Interest earned in a bank deposit is taxable each year. However, if a unit holder allows the investment to grow in a mutual fund scheme (which in turn is exempt from tax), then no income tax is payable on year to year accretions. In the absence of the drag of annual taxation, the money can grow much faster in a mutual fund scheme.

- Mutual funds offer various facilities to make it easy for investors to move their money between different kinds of mutual fund schemes. These are not available with a bank deposit.

10.4.2 MIS for Regular Income

An investor looking for regular income, such as in retirement, invest in the Post office Monthly Income Scheme (MIS) or the Senior Citizen Savings Schemes for guaranteed income, among others. Both these schemes have an upper limit for investment which limits the amount of income that can be earned from them as well as fixed tenure after which they have to be renewed. The Monthly Income Plan (MIP) of mutual funds are debt oriented hybrid schemes that take some exposure to equity to provide a regular income to the investors. There is no upper limit on the investment that can be made in the scheme and they are open-ended scheme. Though there is no guarantee on the income, there are schemes that have a history of uninterrupted dividend payment for the investor. The interest income from the MIS and SCSS are taxable in the hands of the investor. The pay outs from mutual fund MIPs can be structured as dividends or Systematic Withdrawals (capital gains) depending upon which is more tax efficient for the investor. For an investor drawing regular income from primarily debt sources, the MIP can be one more source of income with a small equity exposure.

10.4.3 Equity funds for Equity Investing

Equity investing requires research, analysis, monitoring and rebalancing to ensure that the investor's equity portfolio outperforms the benchmark. This requires skill and time that most investors may not have. Moreover, a diversified portfolio is essential to manage the risk in equity investing. Individual investors may not have the corpus necessary to effectively diversify into sectors and stocks. An equity fund is a professionally managed portfolio. Apart from an experienced fund manager who makes the fund management decisions, the selection and rebalancing of the portfolio is supported by a research and analysis team. Investors can participate in a well-diversified portfolio even with a small investment. The costs and expenses associated with directly investing in equity is much more than the expenses charged to a mutual fund scheme.

10.4.4 ELSS for tax saving

Investors have multiple saving products such as NSC, PPF, Bank deposits and others which enable them to save tax under section 80 C of the Income Tax Act. These products are debt investments, and while they may provide guaranteed returns they do not provide the capital appreciation that will effectively beat inflation. ELSS are equity mutual funds that are also permitted investments under section 80 C. Along with tax savings, they provide capital appreciation linked to equity investments. The dividends and capital gains earned from the scheme are exempt from tax. The lock-in period in the ELSS is the lowest at 3 years while compared to the 15 years in PPF, 5 /10 years in NSC and 5 years in bank fixed deposits, among others.

10.4.5 Retirement Plans from Mutual Funds

Accumulating the corpus for retirement has conventionally been done through products such as employee provident funds, public provident fund and other debt-oriented investments. Given the long investment horizon for the retirement goal, the investor can take some exposure to equity to optimize the returns from the money being accumulated. Retirement plans of mutual funds are debt-oriented hybrid schemes that take some exposure to equity, typically 25% to 40%. The better returns that these funds provide can enhance the retirement corpus and can form one more investment avenue for retirement planning along with the others traditional options.

10.5 National Pension System (NPS)

Pension Funds Regulatory and Development Authority (PFRDA) is the regulator for the National Pension System. Two kinds of pension accounts are offered:

- Tier I (Pension account), is non-withdrawable.
- Tier II (Savings account) is withdrawable to meet financial contingencies. An active Tier I account is a pre-requisite for opening a Tier II account.
- Investors can invest through Points of Presence (POP). They can allocate their investment between 3 kinds of portfolios:
    - Asset Class E: Investment in predominantly equity market instruments
    - Asset Class C: Investment in Debt securities other than Government Securities
    - Asset Class G: Investments in Government Securities.

Between the above three, Asset class E is the riskier portfolio, since it invests in equity market instruments, whereas Asset class G, with investment in Government Securities, carries lowest risk. Asset class C carries the risk of default as it invests in debt securities other than Government Securities. These securities are issued by private issuers.

Investors can also opt for life-cycle fund. With this option, the system will decide on a mix of investments between the 3 asset classes, based on age of the investor. As the name suggests, the combination of the asset classes is a function of the life-cycle an investor is in. As the age advances, the allocation to the three different asset classes will be changed in accordance with a pre-determined mix.

The 3 asset class options are managed by 8 Pension Fund Managers (PFMs). These PFMs are authorised by PFRDA. SEBI registered AMCs do not get automatic approval for management of NPS. In fact, an AMC interested in managing NPS money will have to float a separate company for the purpose.

The investors' moneys can thus be distributed between 3 portfolios X 8 PFMs = 24 alternatives.

The NPS offers fewer portfolio choices than mutual funds. However, NPS offers the convenience of a single Permanent Retirement Account Number (PRAN), which is applicable across all the PFMs where the investor's money is invested. PRAN is a unique ID number for NPS investments and it is portable. Thus, when an individual changes the employer or the fund, the PRAN still remains associated with the investor. It is the identity of the investor when it comes to NPS.

Further, the POPs offer services related to moneys invested with any of the PFMs.

10.6 Other Financial Products

The inherent risk and return characteristics vary between financial products. The discussions in this and the previous units give a good perspective on the key parameters on which various financial products need to be compared, before investment decisions are taken.

Sample Questions

1. **More than 50% of the wealth of Indians is held in physical assets.**

   a. True
   b. False

2. **Gold Futures are superior to ETF Gold as a vehicle for life-long investment in gold.**

   a. True
   b. False

3. **As regards wealth tax, ETF Gold is superior to physical gold.**

   a. True
   b. False

4. **The National Pension System is regulated by ______.**

   a. SEBI
   b. IRDAI
   c. PFRDA
   d. AMFI

5. **An investor under the National Pension System can choose which of the following asset classes?**

   a. Equities
   b. Corporate debt
   c. Government Securities
   d. All of the above

CHAPTER 11: HELPING INVESTORS WITH FINANCIAL PLANNING

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Need for financial planning
- Steps of Financial planning
- Profiling of Investors according to--life cycle, wealth cycle, risk appetite

11.1 Introduction to Financial Planning

11.1.1 What is Financial Planning?

Everyone has needs and aspirations. Most needs and aspirations call for a financial commitment. Providing for this commitment becomes a financial goal. Fulfilling the financial goal sets people on the path towards realizing their needs and aspirations. People experience happiness, when their needs and aspirations are realized within an identified time frame.

For example, a father wants his son, who has just passed his 10^{th} standard Board examinations, to become a doctor. This is an aspiration. In order to realize this, formal education expenses, coaching class expenses, hostel expenses and various other expenses need to be incurred over a number of years. The estimated financial commitments towards these expenses become financial goals. These financial goals need to be met, so that the son can become a doctor.

The needs or aspirations are a good starting point, but in order to plan, these need to be converted into financial goals. The financial goals must be defined in terms of time horizon and the amount of money required to fund the goal.

In the above example, the father has to plan (financially) for funding the son's medical education. For that purpose, one needs to know the time when the son is ready to go to the medical college, which will be after 2 years, in this example as the son has just passed his 10^{th} standard examination. The father also needs to estimate the amount required for tuition fees and other related expenses.

Financial planning is a planned and systematic approach to provide for the financial goals that will help people realise their needs and aspirations, and be happy.

11.1.2 Assessment of Financial Goals

The financial goals related to making the son a doctor, call for commitments over a period of about 6 years – 2 years of under-graduate studies, coaching class expenses for preparing for the medical entrance exams, followed by the medical education and hostel expenses.

An estimate of these future expenses (the financial goals) requires the following inputs:

Year	Current Cost (Rs)	Likely Inflation (% p.a.)	Likely Exchange Rate impact (% p.a.)
1	100,000	7%	N.A.
2	120,000	7%	N.A.
3	1,000,000	7%	N.A.
4	500,000	7%	N.A.
5	500,000	7%	N.A.
6	500,000	7%	2%

- How much would be the expense, if it were incurred today?
- How many years down the line, the expense will be incurred?
- During this period, how much will the expense rise on account of inflation?
- If any of these expenses are to be incurred in foreign currency, then how would changes in exchange rate affect the financial commitment?

Suppose the inputs are as follows:

The costs mentioned above, in today's terms, need to be translated into the rupee requirement in future. This is done using the formula $A = P \times (1 + i)^n$, where,

A = Rupee requirement in future

P = Cost in today's terms

i = inflation

n = Number of years into the future, when the expense will be incurred.

The below-mentioned calculations can be done on calculator. However, the calculations are easier, using MS Excel formulae.

For instance, the Rs120,000 money requirement of 2 years down the line, calculated at today's prices, translates into a future rupee requirement of "=120,000 X (1 + 7%) ^ 2" (as entered in MS Excel). The answer is Rs 137,388.

The same exercise done for the other year's expenses gives a year-wise future rupee requirement as follows:

Year	MS Excel Formula	Future Rupee Requirement (Rs)
1	=100,000 X (1 + 7%) ^ 1	107,000
2	=120,000 X (1 + 7%) ^ 2	137,388
3	=1,000,000 X (1 + 7%) ^ 3	1,225,043
4	=500,000 X (1 + 7%) ^ 4	655,398
5	=500,000 X (1 + 7%) ^ 5	701,276
6	=500,000 X (1 + 7% + 2%) ^ 6	838,550*

* Strictly, it should be calculated as 500,000 X (1 + 7%) X(1 + 2%). The above formula is an acceptable approximation.

These are the financial goals that need to be met, in order to realize the aspiration of seeing the son become a doctor.

11.1.3 Investment Horizon

The year-wise financial goals statement throws up the investment horizon. This is important in identifying the suitable investment option to create the corpus.

In most cases, the investor would have some regular income out of which part of the expenses can be met. So the investments being considered now need to fund only the balance of the financial goals.

11.1.4 Assessing the Fund Requirement

Suppose the investor is comfortable about meeting Rs 100,000 of the expense each year. The balance would need to be provided out of investments being made today. How much is that investment requirement? Or, if an investor needs a sum of Rs. 5 lakhs for one of his goals 2 years from now, how much should he invest if the expected return on investment is 8% p.a.?

This can be calculated using a variation of the formula used earlier i.e. $P = A \div (1 + r)^{n}$, where:

P, A and n have the same meaning as in the earlier formula.

r represents the return expected out of the investment portfolio.

Suppose requirements of Years 1 to 3 are met out of debt investments that would yield a return of 6% p.a. The requirements of Year 4 onwards are met out of equity investments that are estimated to yield a return of 9% p.a. The amount that would need to be invested today is as follows:

Year	Required (Rs)	Regular Savings (Rs)	Balance Required (Rs)	MS Excel Formula	Investment Required Today (Rs)
1	107,000	100,000	7,000	=7000/ (1+6%)^1	6,604D
2	137,388	100,000	37,388	=37388/ (1+6%)^2	33,275D
3	1,225,043	100,000	1,125,043	=1125043/ (1+6%)^3	944,608D
4	655,398	100,000	555,398	=555398/ (1+9%)^4	393,458E
5	701,276	100,000	601,276	=601276/ (1+9%)^5	390,788E
6	838,550	100,000	738,550	=738550/ (1+9%)^1	440,373E
Total					**22,09,106**

Thus, a total amount of Rs 22,09,106 needs to be invested right now – Rs 984,487 in debt with a 3-year horizon, and Rs 12,24,619 in equity with a 4 – 6 year horizon to meet the financial goals that would help the investor realize the aspiration of seeing his son become a doctor.

While the estimation of the goal value calls for an assumption regarding inflation, the amount required for investment also must consider the expected rate of return from the chosen investment.

Many AMCs and websites offer calculators that help with the above calculations.

11.1.5 Financial Planning Objectives and Benefits

The objective of financial planning is to ensure that the right amount of money is available at the right time to meet the various financial goals of the investor. This would help the investor realize his aspirations and experience happiness. It gives direction to the investor’s spending and saving habits.

An objective of financial planning is also to let the investor know in advance, if some financial goal is not likely to be fulfilled. In the above case, the investor knows that if he cannot make the requisite combined investment of Rs 21,33,238 in debt and equity today, then financial constraints may affect the realization of his aspiration.

Thanks to advance information available through financial planning, timely corrective actions can be taken, such as:

- Reviewing what is a “need” and what is a “desire” that can be postponed for the more desirable objective of realizing the aspiration of son becoming a doctor.
- Moving to a smaller house, or a house in a less expensive locality, to release more capital.
- Improving the future annual savings by economizing on expense, or taking up an extra part-time job, or influencing the spouse to take up employment for some time.
- Considering an education loan to bridge the short fall in funds.

Financial planning thus helps investors realize their aspirations and feel happy. It also helps the financial planner, because the process of financial planning helps in understanding the investor better, and cementing the relationship with the investor’s family. This becomes the basis for a long term relationship between the investor and the financial planner.

11.1.6 Need for Financial Planners

Most investors are either not organized, or lack the ability to make the calculations described above. A financial planner’s service is therefore invaluable in helping people realize their needs and aspirations.

Even if the investor knows the calculations, the knowledge of how and where to invest may be lacking. The financial planner thus steps in to help the investor select appropriate financial products and invest in them.

Transactions such as purchase of house or car, or even education, necessitate a borrowing. The financial planner can help the investor decide on the optimal source of borrowing and structure the loan arrangement with the lender.

Taxation is another area that most investors are unclear about. Financial planners who are comfortable with the tax laws can therefore help the investor with tax planning, so as to optimize the tax outflows.

Financial planners can also help investors in planning for contingencies. This could be through advice on insurance products, inheritance issues etc.

The financial planner thus is in a position to advise investors on all the financial aspects of their life.

11.2 Alternate Financial Planning Approaches

The financial plan detailed above is a "goal-oriented financial plan" – a financial plan for a specific goal related to the aspiration to make the son a doctor.

An alternate approach is a "comprehensive financial plan" where all the financial goals of a person are taken together, and the investment strategies worked out on that basis.

The steps in creating a comprehensive financial plan, as proposed by the Certified Financial Planner – Board of Standards (USA) are as follows:

- Establish and Define the Client-Planner Relationship
- Gather Client Data, Define Client Goals
- Analyse and Evaluate Client's Financial Status
- Develop and Present Financial Planning Recommendations and / or Options
- Implement the Financial Planning Recommendations
- Monitor the Financial Planning Recommendations

The comprehensive financial plan captures the estimated inflows from various sources, and estimated outflows for various financial goals, including post-retirement living expenses. The plan can go several decades into the future.

A comprehensive financial plan calls for significantly more time commitment on the part of both the investor and the financial planner. However, the time commitment needs to be viewed as an investment in a long term relationship.

11.3 Life Cycle and Wealth Cycle in Financial Planning

While working on a comprehensive financial plan, it is useful to have a perspective on the Life Cycle and Wealth Cycle of the investor.

11.3.1 Life Cycle

These are the normal stages that people go through, viz.:

Childhood

During this stage, focus is on education in most cases. Children are dependents, rather than earning members. Pocket money, cash gifts and scholarships are potential sources of income during this phase. Investments made from such sources are typically for the long-term, which makes equity investments viable. Parents and seniors need to groom children to imbibe the virtues of savings, balance and prudence. Values imbibed during this phase set the foundation of their life in future.

Young Unmarried

The earning years start here. At this stage income is likely to be limited while expenses are likely to be high. It is good to get into the habit of saving and a budget may be a good idea to control expenses. Many of the goals are likely to be short and medium term in nature, apart from the mandatory long-term retirement goal.

This is the right age to start investing in equity for the long term goals. Personal plans on marriage, transportation and residence determine the liquidity needs. People for whom marriage is on the anvil, and those who wish to buy a car / two-wheeler or house may prefer to invest more in relatively liquid investment avenues suitable for the shorter investment horizon.

Young Married

A cushion of assets created during the early earning years can be a huge confidence booster while taking up the responsibilities associated with marriage.

Where both spouses have decent jobs, life can be financially comfortable. They can plan where to stay in / buy a house, based on job imperatives, life style aspirations and personal comfort. Insurance is required and there is a greater ability to take risks with investment.

Where only one spouse is working, life insurance to provide for contingencies associated with the earning spouse are absolutely critical. In case the earning spouse is not so well placed, ability to pay insurance premia can be an issue, competing with other basic needs of food, clothing and shelter. In such cases, term insurance (where premium is lower) possibilities have to be seriously explored and locked into.

Expenses are likely to be high at this stage. But with careful planning it is possible to save money.

Depending on the medical coverage provided by the employer/s, health insurance policy cover too should be planned. Even where the employer provides medical coverage, it would be useful to start a low value health insurance policy, to provide for situations when an earning member may quit a job and take up another after a break. Further, starting a health insurance policy earlier and not having to make a claim against it for a few years, is the best antidote to the possibility of insurance companies rejecting future insurance claims / coverage on account of what they call “pre-existing illness”.

While buying a health insurance policy, there has to be clarity on whether it is a cashless policy i.e. a policy where the insurance company directly pays for any hospitalization expenses. In other policies, the policy-holder has to bear the expense first and then claim re-imbursement from the insurer. This increases the liquidity provisions that need to be made for contingencies.

All family members need to know what is covered and what is not covered in the policy, any approved or black listed health services provider, and the documentation and processes that need to be followed to recover money from the insurer. Many insurance companies have outsourced the claim settlement process. In such cases, the outsourced service provider, and not the insurer, would be the touch point for processing claims.

Married with Young Children

Insurance needs – both life and health - increase with every child. The financial planner is well placed to advise on a level of insurance cover, and mix of policies that would help the family maintain their life style in the event of any contingency.

Expenses for education right from pre-school to normal schooling to higher education is growing much faster than regular inflation. Adequate investments are required to cover this. Long-term goals of education, retirement can see allocations being made to equity. Medium term goals like a down payment on a house or foreign holiday can see investments being made in debt.

Married with Older Children

The costs associated with helping the children settle i.e. cost of housing, marriage etc. are shooting up. If investments in growth assets like shares and real estate, are started early in life, and maintained, it would help ensure that the children enjoy the same life style, when they set up their independent families. At this stage, as goals for which the person has been accumulating comes closer, funds will be moved from volatile assets such as equity to more stable debt investments.

Pre-Retirement

By this stage, the children should have started earning and contributing to the family expenses. Further, any loans taken for purchase of house or car, or education of children should have been extinguished. The family ought to plan for their retirement – what kind of lifestyle to lead, and how those regular expenses will be met.

Retirement

At this stage, the family should have adequate corpus, the interest on which should help meet regular expenses. The need to dip into capital should come up only for contingencies – not to meet regular expenses.

The availability of any pension income and its coverage (only for the pensioner or extension to family in the event of death of pensioner) will determine the corpus requirement.

Besides the corpus of debt assets to cover regular expenses, there should also be some growth assets like shares, to protect the family from inflation during the retirement years.

11.3.2 Wealth Cycle

This is an alternate approach to profile the investor. The stages in the Wealth Cycle are:

Accumulation

This is the stage when the investor gets to build his wealth. It covers the earning years of the investor i.e. the phases of the life cycle from Young Unmarried to Pre-Retirement.

Transition

Transition is a phase when financial goals are in the horizon. E.g. house to be purchased, children's higher education / marriage approaching etc. Given the impending requirement of funds, investors tend to increase the proportion of their portfolio in liquid assets viz. money in bank, liquid schemes etc.

Inter-Generational Transfer

During this phase, the investor starts thinking about orderly transfer of wealth to the next generation, in the event of death. The financial planner can help the investor understand various inheritance and tax issues, and help in preparing Will and validating various documents and structures related to assets and liabilities of the investor.

It is never too early to plan for all this. Given the consequences of stress faced by most investors, it should ideally not be postponed beyond the age of 50.

Reaping / Distribution

This is the stage when the investor needs the funds that has been accumulated over time. Hence, investors in this stage would move the funds to asset classes that meet their need for easy access to funds or regular periodic income as the case may be. It is the parallel of retirement phase in the Life Cycle.

Sudden Wealth

Winning lotteries, unexpected inheritance of wealth, unusually high capital gains earned – all these are occasions of sudden wealth, that need to be celebrated. However, given the human nature of frittering away such sudden wealth, the financial planner can channelize the wealth into investments, for the long term benefit of the investor's family.

In such situations, it is advisable to initially block the money by investing in a liquid scheme. An STP from the liquid schemes into equity schemes will help the long term wealth creation process, if advisable, considering the unique situation of the investor. Even if there is a need to invest in equity for the purpose of wealth creation, it is better to invest in tranches to benefit from market volatility.

Given the change of context, and likely enhancement of life style expectations, a review of the comprehensive financial plan is also advisable in such situations.

Understanding of both life cycle and wealth cycle is helpful for a financial planner. However, one must keep in mind that each investor may have different needs and unique situations; the recommendations may be different for different investors even within the same life cycle or wealth cycle stages.

11.3.3 Financial Planning Tools

The financial plan preparation becomes simpler with the aid of packaged software. These help not only in estimating the cash flow requirements and preparing the financial plan, but also ongoing monitoring of the portfolio.

A few mutual funds and securities companies provide limited financial planning tools in their websites. A serious financial planner might like to invest in off-the-shelf software that will enable storing of relevant client information confidentially, and offer ongoing support to the clients.

Sample Questions

1. **Today's costs can be translated into future requirement of funds using the formula:**

   a. $A = P \times (1 + i)^n$
   b. $A = P / (1 + i)^n$
   c. $P = A^n \times (1 + i)$
   d. $P = A^n \times (1 + i)$

2. **Providing funds for a daughter's marriage is an example of _______.**

   a. Goal-oriented Financial Plan
   b. Comprehensive Financial Plan
   c. Financial goal
   d. None of the above

3. **According to the Certified Financial Planner – Board of Standards (USA), the first stage in financial planning is _____________.**

   a. Analyse and Evaluate Client's Financial Status
   b. Establish and Define the Client-Planner Relationship
   c. Gather Client Data, Define Client Goals
   d. Develop and Present Financial Planning Recommendations and / or Options

4. **Investor can get into long term investment commitments in ________.**

   a. Distribution Phase
   b. Transition Phase
   c. Inter-generational Phase
   d. Accumulation Phase

5. **Distribution phase of Wealth Cycle is a parallel of Retirement phase of Life Cycle.**

   a. True
   b. False

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CHAPTER 12: RECOMMENDING MODEL PORTFOLIOS AND FINANCIAL PLANS

LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Factors influencing risk profile of investors
- Concept of asset allocation
- Building different kinds of model portfolios

12.1 Risk Profiling

12.1.1 Need for Risk Profiling

As seen earlier, various schemes have different levels of risk. Similarly, there are differences between investors with respect to the levels of risk they are comfortable with (*risk appetite)*. At times there are also differences between the level of risk the investors *think* they are comfortable with, and the level of risk they *ought to be* comfortable with.

Risk profiling is an approach to understand the risk appetite of investors - an essential pre-requisite to advise investors on their investments.

The investment advice is dependent on understanding both aspects of risk:

- Risk appetite of the investor
- Risk level of the investment options being considered.

12.1.2 Factors that Influence the Investor's Risk Profile

Some of the factors and their influence on risk appetite are as follows:

Factor	Influence on Risk Appetite
Family Information	
• Earning Members	Risk appetite increases as the number of earning members increases
• Dependent Members	Risk appetite decreases as the number of dependent members increases
• Life expectancy	Risk appetite is higher when life expectancy is longer

Personal Information	
• Age	Lower the age, higher the risk that can be taken
• Employability	Well qualified and multi-skilled professionals can afford to take more risk
• Nature of Job	Those with steady jobs are better positioned to take risk
• Psyche	Daring and adventurous people are better positioned mentally, to accept the downsides that come with risk
Financial Information	
• Capital base	Higher the capital base, better the ability to financially take the downsides that come with risk
• Regularity of Income	People earning regular income can take more risk than those with unpredictable income streams

More such factors can be added. The financial planner needs to judge the investor based on such factors, rather than just ask a question "How much risk are you prepared to take?"

Thus, someone with a stable job may be considered to have higher risk appetite than someone struggling to get a job. Similarly, a qualified person (since the employability goes up) may be considered to have higher risk appetite than an unqualified person.

12.1.3 Risk Profiling Tools

Some AMCs and securities research houses provide risk profiling tools in their website. Some banks and other distributors have proprietary risk profilers. These typically revolve around investors answering a few questions, based on which the risk appetite score gets generated.

Some of these risk profile surveys suffer from the investor trying to "guess" the right answer, when in fact there is no right answer. Risk profiling is a tool that can help the investor; it loses meaning if the investor is not truthful in his answers.

Some advanced risk profilers are built on the responses to different scenarios that are presented before the investor. Service providers can assess risk profile based on actual transaction record of their regular clients.

While such tools are useful pointers, it is important to understand the robustness of such tools before using them in the practical world. Some of the tools featured in websites have their limitations. The financial planner needs to use them judiciously.

12.2 Asset Allocation

12.2.1 The Role of Asset Allocation

'Don't put all your eggs in one basket' is an old proverb. It equally applies to investments.

The discussion on risk in Chapter 8, highlighted how the risk and return in various asset classes (equity, debt, gold, real estate etc.) are driven by different factors. Different economic conditions may impact the performance of different asset classes differently. For example, during the recessionary situation in 2007-09, equity markets in many countries fared poorly, but gold prices went up. Thus, an investor who had invested in both gold and equity, earned better returns than an investor who invested in only equities. The distribution of an investor's portfolio between different asset classes is called *asset allocation.*

Economic environments and markets are dynamic. Predictions about markets can go wrong. With a prudent asset allocation, the investor does not end up in the unfortunate situation of having all the investments in an asset class that performs poorly. Thus, the purpose of asset allocation is not to enhance returns, but to reduce the risk. The risk in a portfolio can be reduced by bringing together asset classes whose performance are not affected by the same factors or in the same way. Correlation measures the extent to which the returns from two asset classes move together. Correlation ranges from -1 to +1. The risk in a portfolio can be reduced by bringing together asset classes with low correlation.

Some international researches suggest that asset allocation and investment policy can better explain portfolio performance, as compared to selection of securities within an asset class (stock selection) and investment timing.

12.2.2 Asset Allocation Types

In the discussion on risk in balanced schemes in Chapter8, the concept of flexible asset allocation was introduced. It was reasoned that these are more risky than balanced funds with more stable asset allocation policies. Balanced funds that adopt such stable asset allocation policies, e.g. 65:35 between equity and debt at all times, are said to be operating within a fixed asset allocation framework.

At an individual level, difference is made between Strategic and Tactical Asset Allocation.

Strategic Asset Allocation is the ideal that comes out of the risk profile of the individual, the return requirement to meet the goals and the investment horizon. Risk profiling is key to deciding on the strategic asset allocation. The allocation to the various asset classes is not driven by their expected performance. The most simplistic risk profiling thumb rule is to have as much debt in the portfolio, as the number of years of age. As the person grows older, the debt component of the portfolio keeps increasing. This is an example of strategic asset allocation.

As part of the financial planning process, it is essential to decide on the strategic asset allocation that is advisable for the investor. The asset allocation will change if there is a change in the risk and return preferences of the investor.

Tactical Asset Allocation is the decision that comes out of calls on the likely behaviour of the market. An investor who decides to go overweight on equities i.e. take higher exposure to equities, because of expectations of buoyancy in industry and share markets, is taking a tactical asset allocation call.

Tactical asset allocation is suitable only for seasoned investors operating with large investible surpluses. Even such investors might like to set a limit to the size of the portfolio on which they would take frequent tactical asset allocation calls.

The last step in the process of portfolio construction would be selection of schemes within the agreed asset allocation.

12.3 Model Portfolios

Since investors' risk appetites vary, a single portfolio cannot be suggested for all. Financial planners often work with model portfolios – the asset allocation mix that is most appropriate for different risk appetite levels. The list of model portfolios, for example, might read something like this:

Young call centre / BPO employee with no dependents

50% diversified equity schemes (preferably through SIP); 20% sector funds; 10% gold ETF, 10% diversified debt fund, 10% liquid schemes.

Young married single income family with two school going kids

35% diversified equity schemes; 10% sector funds; 15% gold ETF, 30% diversified debt fund, 10% liquid schemes.

Single income family with grown up children who are yet to settle down

35% diversified equity schemes; 10% Index fund, 15% gold ETF, 30% diversified debt fund, 10% liquid schemes.

Couple in their seventies, with no immediate family support

15% diversified equity index scheme; 10% gold ETF, 30% diversified debt fund, 30% MIP, 15% liquid schemes.

As the reader would appreciate, these percentages are illustrative and subjective. The critical point is that the financial planner should have a model portfolio for every distinct client profile. This is then tweaked around based on specific investor information.

Within each of these scheme categories, specific schemes and options can be identified, based on the approach described in Chapter10.

Sample Questions

1. **Risk appetite of investors is assessed through _______.**

    a. Risk Appetizers
    b. Asset Allocators
    c. Risk Profilers
    d. Financial Plan

2. **The objective of asset allocation is risk management.**

    a. True
    b. False

3. **The asset allocation that is worked out for an investor based on risk profiling is called _______.**

    a. Tactical Asset Allocation
    b. Fixed Asset Allocation
    c. Flexible Asset Allocation
    d. Strategic Asset Allocation

4. **Model portfolios are a waste of time for financial planners.**

    a. True
    b. False

5. **How much equity would you suggest for a young well settled unmarried individual**

    a. 100%
    b. 80%
    c. 60%
    d. 40%

List of Abbreviations

A/A	Articles of Association
ACE	AMFI Code of Ethics
AMC	Asset Management Company
AMFI	Association of Mutual Funds in India
AML	Anti-Money Laundering
ARN	AMFI Registration Number
ASBA	Application Supported by Blocked Amount
CAGR	Compounded Annual Growth Rate
CDSC	Contingent Deferred Sales Charge
CFT	Combating Financing of Terrorism
CVL	CDSL Ventures Ltd
DD	Demand Draft
DDT	Dividend Distribution Tax (Additional Tax on Income Distribution)
DP	Depository Participant
ECS	Electronic Clearing Service
F&O	Futures & Options
FCNR	Foreign Currency Non-Resident account
FEMA	Foreign Exchange Management Act, 1999
FII	Foreign Institutional Investor
FIRC	Foreign Inward Remittance Certificate
FMP	Fixed Maturity Plan
HUF	Hindu Undivided Family
IPV	In Person Verification
ISC	Investor Service Centre
KIM	Key Information Memorandum
KRA	KYC Registration Agency
KYC	Know Your Customer
M/A	Memorandum of Association
M-Banking	Mobile Banking
MF	Mutual Fund
Micro-SIP	SIP with annual aggregate investment less than Rs50,000
NAV	Net Asset Value
NBFC	Non-Banking Finance Company
NEFT	National Electronic Funds Transfer
NFO	New Fund Offer
NOC	No Objection Certificate
NPA	Non-Performing Asset
NRE	Non-Resident External account

NRI	Non-Resident Indian
NRO	Non-Resident Ordinary account
OCI	Overseas Citizenship of India
PAN	Permanent Account Number
PDC	Post-Dated Cheques
PFM	Pension Fund Manager
PFRDA	Pension Fund Regulatory & Development Authority
PIO	Person of Indian Origin
PMLA	Prevention of Money Laundering Act
PoA	Power of Attorney/ Points of Acceptance, depending on context
POP	Points of Presence
QFI	Qualified Foreign Investors
RBI	Reserve Bank of India
RTA	Registrars & Transfer Agents
RTGS	Real Time Gross Settlement
SAI	Statement of Additional Information
SEBI	Securities & Exchange Board of India
SID	Scheme Information Document
SIP	Systematic Investment Plan
SRO	Self-Regulatory Organisation
STP	Systematic Transfer Plan
STT	Securities Transaction Tax
SWP	Systematic Withdrawal Plan
SWIFT	Society for Worldwide Interbank Financial Telecommunication

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