

NiSM

National Institute of Securities Markets

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Workbook for  
NISM-Series-V-B:  
Mutual Fund Foundation  
Certification Examination

**Workbook for**  
**NISM-Series-V-B: Mutual Fund Foundation**  
**Certification Examination**



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## **NISM-Series-V-B: Mutual Fund Foundation 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 Foundation.

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Candidates are advised to go through the corrigendum, if any, received along with the printed copy of the workbook.

### **About NISM**

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

SEBI, by establishing NISM, has articulated the desire expressed by the Indian government to promote securities market education and research.

Towards accomplishing the desire of Government of India and vision of SEBI, NISM has launched an effort to deliver 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 the educational needs of various constituencies such as investor, issuers, intermediaries, regulatory staff, policy makers, academia and future professionals of securities markets.

NISM brings out various publications on securities markets with a view to enhance knowledge levels of participants in the securities industry.

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

### **Acknowledgement**

This workbook has been developed by NISM in cooperation with the Examination Committee for Mutual Fund Distributors Certification Examination consisting of representatives of Association of Mutual Funds in India (AMFI). NISM gratefully acknowledges the contribution of all committee members.

### **About the Author**

This workbook has been developed for NISM by Mr. Sundar Sankaran, Director, Finberry Academy.

### About the Certification Examination for Mutual Fund Foundation

The examination seeks to create common minimum knowledge benchmark for new cadre of mutual fund distributors, as per SEBI circular CIR/IMD/DF/21/2012 dated September 13, 2012, involved in selling and distributing simple and performing mutual fund schemes:

- Postal agents
- Retired government and semi-government officials (class III and above or equivalent) with a service of at least 10 years
- Retired teachers with a service of at least 10 years
- Retired bank officers with a service of at least 10 years, and other persons as may be notified by AMFI/AMC from time to time

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
- Know how mutual funds are distributed in the market-place, how specified schemes are to be evaluated and how suitable schemes can be recommended by this cadre of distributors to prospective investors.
- Know the rules and regulations related to distribution of specified products.
- Know the basics of financial planning as an approach to investing in mutual funds.

### Assessment Structure

The examination consists of 50 questions of 1 mark each and should be completed in 2 hours. The passing score on 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](http://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:

- Mutual Funds as an investment avenue
- Basic operations of a mutual fund
- Mutual fund transactions by an investor
- Concept of Assets Under Management (AUM)
- Role of distributors in mutual fund industry
- Advantages and disadvantages of investing in mutual fund

### 1.1. Mutual Funds – An Investment Solution

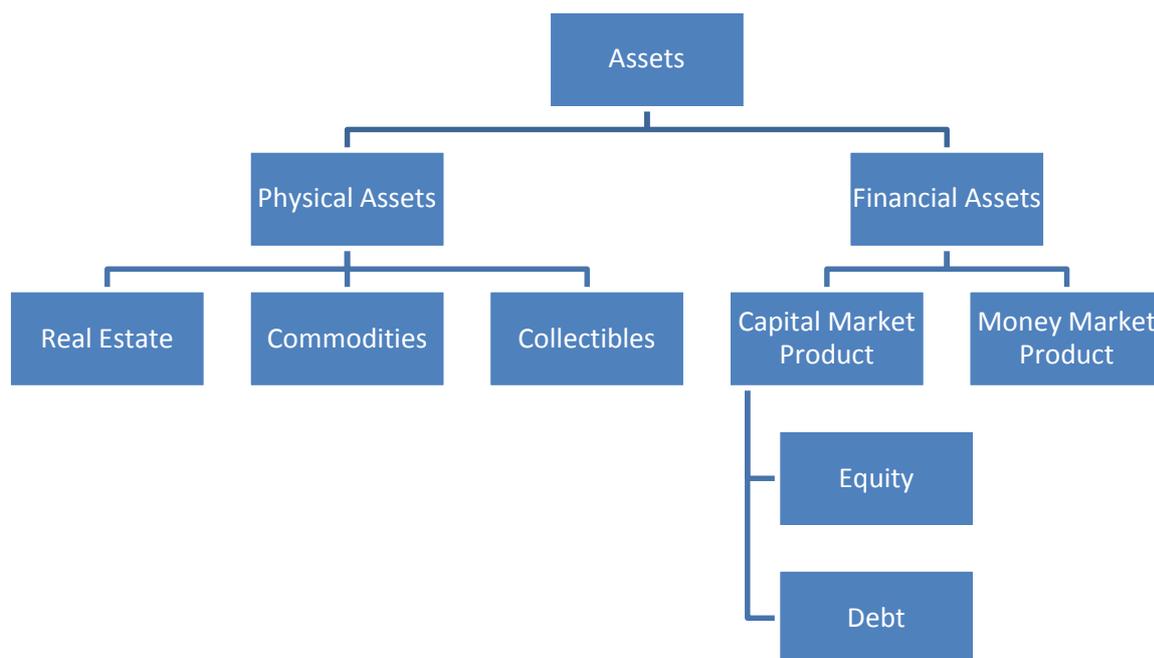
Households invest savings in conventional investment avenues like Fixed Deposit (FD), Post Office Deposits, National Savings Certificate (NSC), Public Provident Fund (PPF) and such other investments. They may also invest in real estate, gold, equity shares<sup>1</sup> and debentures<sup>2</sup>.

The following chart highlights the structure of various categories of assets:

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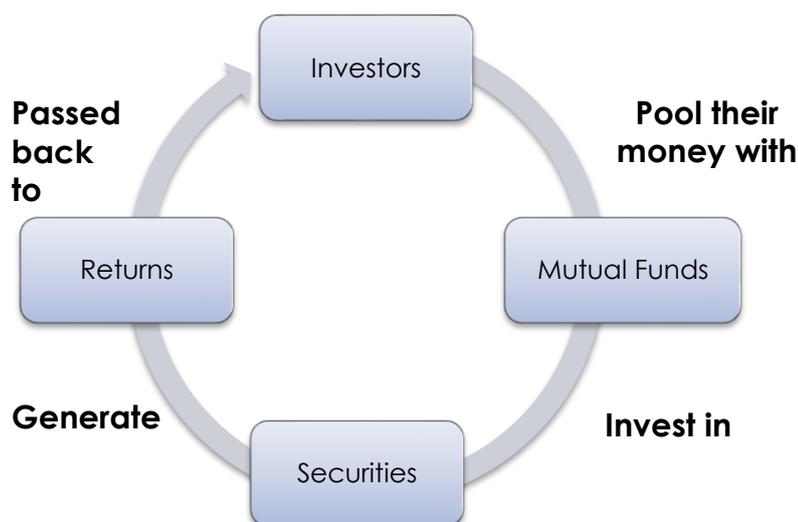
<sup>1</sup>Equity shares are issued by companies. These entitle the shareholder to get a share in the profits of the company. Shareholders receive this profit share in the form of dividends that the company declares from time to time. Trading of these shares in the stock exchange/s give investors the opportunity to benefit from changes in their valuation. If the share price moves adversely, then a loss is possible too.

<sup>2</sup>Debentures / bonds, like FDs, entitle the investor to a certain interest until they are paid back (redeemed at their redemption value) on maturity. These are issued by various companies, banks and financial institutions (issuers). Debentures (unlike FDs) may be traded in the stock exchange. Thus, investors can earn profits or incur losses on change in value of their debenture investments, if they choose to trade in them before maturity. However, on maturity, the entire redemption value is payable by the issuer.



Assets are broadly classified into Financial Assets and Physical Assets. Financial assets are also called securities, and can be debt or equity or money market instruments and these investments help the economy grow. Physical assets like gold, property and the like do not contribute directly to the growth of the economy and may be available in securities form too. Mutual Fund does not figure in the chart above as an investment product as it can be structured as equity, debt, commodity or any product mix- it is a pass through vehicle.

The below given chart illustrates the concept flow of a Mutual Fund product:



Mutual funds offer several such schemes to cater to the needs of different types of investors. The objective of the scheme is announced at the time of scheme launch. Investors can decide to invest in only schemes that offer them the kind of financial market exposure that they are looking for.

Mutual funds are closely regulated by Securities & Exchange Board of India (SEBI) with a view to protect investors. SEBI (Mutual Funds) Regulations, 1996 sets out the regulatory framework.

Association of Mutual Funds in India (AMFI) is an industry body constituted by mutual funds in the country. It works closely with SEBI to address various mutual fund related regulatory issues, and ensure smooth functioning of the industry.

### 1.2. Mutual Funds: Multiple Roles

Besides helping investors build their wealth through investment in financial markets, mutual funds perform several other roles:

- The moneys mobilised from investors are translated into productive capital for various business entities in which the schemes invest.
- As large investors, mutual funds are able to monitor the activities of the controlling shareholders and management of the companies they invest in.
- The money that goes into new projects or expansion of existing projects, boosts overall economic activity and employment in the country.
- The mutual fund industry itself provides employment or a source of livelihood to lakhs of people who are associated with the industry. This includes mutual fund employees, distributors and employees of various service providers.
- Some schemes invest in government securities, thus channelling money for the various activities of the government.

### 1.3. A Snapshot of Mutual Fund Operations

Mutual funds announce the investment objective for every scheme they float, and seek investments from the public. When a scheme is open for investment for a limited period, initially, it is called a *New Fund Offer (NFO)*.

Depending on how it is structured, the scheme may be open to accept money from investors only during the NFO (*closed-end scheme*), or it may accept money post-NFO too (*open-end scheme*).

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. For example, if an investor has invested Rs 1,000 in units issued at Rs 10, he will be entitled to Rs  $1,000 \div Rs 10$  i.e. 100 units.

The purchase of units by the investor from the scheme is also called *subscription*. Refund of money to the investor by the scheme is called *redemption*.

Under the law, every unit has a face value of Rs10. (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 (Rs10) 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* or *unrealised gains*. Similarly, there can be *valuation losses* or *unrealised losses*, when securities are quoted in the market at a price below the cost at which the scheme acquired them.

The practice of marking securities to their market value is called *marked to market (MTM) valuation*. The true worth of each unit of every scheme i.e. its *Net Asset Value (NAV)* is calculated based on MTM valuation of the investment portfolio. Thus, it captures all the gains and losses, realised and unrealised, besides the interest and dividend income earned.

Under the regulations, MTM is to be done daily. This is the principal reason the NAV of the scheme fluctuates, even if there is no change in the investments held in the portfolio of the scheme.

A fall in the security values in the market at the end of a day can cause a drop in NAV; the following day, if the market recovers, the NAV too will recover. Thus, while NAV of mutual fund schemes fluctuate, the fluctuation is of little relevance to a long term investor; the investor's actual returns depend on the price at which he buys and sells the units of the scheme, and the dividend he receives from the scheme during the period he holds the units.

Running the scheme entails costs viz. *scheme running expenses*. The expenses pull down the profits of the scheme and the NAV of the units. This brings down the returns for the investors. Therefore, SEBI has restricted the expenses that can be charged to mutual fund schemes. This has helped in positioning mutual funds among the lowest cost investment products in India.

The scheme's investment operation 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 running expenses

It may be noted, (D) and (F) are a result of MTM valuation.

When the investment activity in a scheme is profitable, the NAV goes up; when there are losses, the NAV goes down.

### 1.4. A Snapshot of Investors' Transactions with Scheme

During the NFO, investors may have the chance of buying the units at their face value of Rs 10. 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 as per the investment objective committed. Profits or losses, as the case might be, belong to the investors. 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:

- In a *growth option*, the scheme does not declare a dividend. So the entire investment performance is captured in its NAV.
- In a *dividend option*, the scheme declares a dividend from time to time. Since dividend comes out of net assets of the scheme, the NAV of the dividend option goes down after a dividend. This reduced NAV is called *ex-dividend NAV*. The dividend option can have two sub-options:
  - *Dividend pay-out*, where dividend is paid to the investor.
  - *Dividend re-investment*, where dividend is declared but retained in the scheme. Instead of money, the investor is given new units against the dividend. The units are allotted at the ex-dividend NAV.

For example, if the NAV of the dividend option of a scheme is Rs 26 per unit. It declares a dividend of Rs 1 per unit.

In the absence of any other tax implication, the ex-dividend NAV will be Rs 25 per unit.

Suppose that an investor holds 1,000 units in each sub-option.

- Under the dividend pay-out option, the investor will receive Rs1 per unit X 1,000 units i.e. Rs 1,000 in the bank.
- Under the dividend re-investment option, the investor is entitled to dividend of Rs1 per unit X 1,000 units i.e. Rs 1,000. This will be re-invested at the ex-dividend NAV. The investor will be issued  $\text{Rs } 1,000 \div \text{Rs } 25$  i.e. 40 new units of the scheme. Thus, instead of

receiving Rs 1,000 in the bank, the investor in dividend re-investment option will receive 40 additional units.

- Since dividend is not distributed in the growth option, its NAV will be higher than the NAV of the dividend option for the same scheme. Accordingly the price that an investor will realise on selling his units too is likely to be higher for the growth option. Thus, he is compensated for the dividend that he has forgone in the scheme.

Some investors prefer to invest directly i.e. without the assistance of distributors. Mutual fund schemes offer 'Direct' plans for the benefit of such investors. The NAV of the 'Direct plan' is different from the NAV of the Distributor plan. The Direct plan and Distributor plan NAVs would again be different for Growth and Dividend options.

### 1.5. Assets Under Management

The relative size of mutual fund companies is evaluated by their *assets under management (AUM)*. The AUM of a mutual fund is the sum of the AUM of all its schemes.

When a scheme is first launched, its AUM is the amount mobilized from investors. Thereafter, income, realised gains and valuation gains earned by the scheme will boost its AUM. Expenses, realised losses and valuation losses will bring down the AUM.

Further, in an open-end scheme, new investments from investors will raise the AUM. Conversely, if the scheme pays any money to the investors, either as dividend or as consideration for buying back (redeeming) 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.

### 1.6. New Cadre of Distributors

The mutual fund industry offers various mutual fund schemes that investors can invest in. These help investors take various kinds of exposures, such as debt, equity, gold or a mix of these assets. Agents / distributors perform a useful role in helping investors decide on the schemes to invest in, and make the investment.

SEBI has stipulated that agents/ distributors of mutual fund units are required to obtain certification from the National Institute of Securities Markets (NISM) and registration from AMFI. These are discussed in Chapter 7.

Multiple schemes available in the market can make it complex for distributors to sell and investors to buy mutual fund schemes. However, most investors need not go beyond simple and performing mutual fund schemes to address their investment needs. With this in mind, SEBI proposed the creation of a new cadre of distributors who are authorised to sell only such simple and performing mutual fund schemes.

The new cadre of distributors includes the following categories of people:

- Postal agents, Retired government and semi-government officials (class III and above or equivalent) with a service of at least 10 years
- Retired teachers with a service of at least 10 years
- Retired bank officers with a service of at least 10 years

AMFI has included the following persons in the new cadre of distributors:

- Intermediaries/ Agents engaged in distribution of financial products e.g. insurance agent, FD agent, National Savings Scheme products, PPF, etc. registered with any other Financial Services Regulator
- Business correspondents appointed by banks

The simple mutual fund schemes that the new cadre of distributors can distribute are as follows:

- Fixed Maturity Plans
- Index Schemes
- Diversified Equity Schemes shall be Large Cap oriented and well diversified schemes and shall not include the following;
  - Thematic / Sector funds
  - Small Cap, Mid Cap or Micro Cap Fund
  - Concentrated Funds i.e. number of stocks less than 30 as per offer document

These schemes are explained in Chapter 3. Schemes that have performed better than their benchmark (explained in Chapter 4) in each of the previous three years are considered to be '*performing*'.

The new cadre of distributors, thus, have an opportunity to serve the needs of their customers, friends, relatives and associates, and supplement their income through the distribution of such simple and performing mutual fund schemes.

NISM-Series-V-B: Mutual Fund Foundation Certification Examination is the mandatory examination for all persons who wish to sell only such simple and performing schemes.

Those who wish to sell a wider array of mutual fund schemes will need to pass NISM-Series-V-A: Mutual Fund Distributors Certification Examination as detailed in Chapter 7.

### 1.7. 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:** 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 5,000 in a mutual fund scheme can give investors a diversified investment portfolio.

With diversification, an investor ensures that all his egg are not in the same basket. Even if some investments in the scheme portfolio lose money, other investments in the portfolio can make up for the loss. 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 lakh of rupees. Instead, they can achieve the diversification through an investment of a few 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 operation and underlying risks. 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. SEBI has fixed a limit on the brokerage that the schemes can pay on their purchases and sales of securities in the market. Similarly, there is a cap on the total expenses of every scheme.

- **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 (*open-end schemes*), or during specific intervals (*interval fund*), or only on closure of the scheme (*closed-end schemes*).

Closed-end schemes are listed in a stock exchange. Thus, before the scheme matures, the investor can sell the units in the stock exchange to recover the prevailing value of the investment.

- **Tax Deferral:** 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.

Through the growth option in a scheme, the investor can let the moneys grow in the scheme for several years without any incidence of taxation. 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:** The dividend that the investor receives from any mutual fund scheme is tax-free in his hands.

Investment in specific schemes of mutual funds (*Equity Linked Savings Schemes - ELSS*) can be reduced from the investor's income that is liable to tax. This reduces their taxable income, and therefore the tax liability. The ELSS investment limit is Rs 1 lakh per financial year, along with other eligible investments such as life insurance premium, PPF, NSC etc. The Rajiv Gandhi Equity Savings Scheme (RGESS) offers a rebate to first time retail investors with annual income below Rs 12 lakhs. 50% of the amount invested (excluding brokerage, securities transaction tax, service tax, stamp duty and all taxes appearing in the contract note) can be claimed as a deduction from taxable income. Although any amount can be invested in such scheme, the benefit is only available up to Rs 50,000. Thus, the deduction is limited to 50% of Rs 50,000, i.e., Rs 25,000. The investment of Rs 50,000 can be spread over a block of 3 financial years. Once RGESS deduction of upto Rs 25,000 is claimed in upto 3 financial years, no further RGESS deduction can be claimed by that investor in any future years. Mutual funds announce specific schemes that are eligible for the RGESS deduction.

- **Convenient Options:** The options offered under a scheme viz. growth and dividend, allow investors to structure their investments in line with their liquidity preference and tax position.
- **Investment Comfort:** The Know-Your-Customer (KYC) requirements are centralised across the capital markets, including mutual funds. Therefore, based on a single KYC process, investors can invest across the capital market in shares, debentures, mutual funds etc.

Further, once an investment is made with a mutual fund, the investor can make further purchases with very little documentation. This simplifies subsequent investment activity.

- **Systematic Approaches to Investment:** Mutual funds also offer facilities that help investor invest 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 an investment discipline, which is useful in long term wealth creation and protection.
- **Regulatory Comfort:** SEBI has mandated strict checks and balances in the structure of mutual funds and their activities. These are detailed in the next Chapter of this workbook. Mutual fund investors benefit from such protection.

## 1.8. Limitations of Mutual Funds

- **Lack of Portfolio Customisation:** 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.

On the other hand, a unit-holder 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 1,400 mutual fund schemes offered by 41 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 for the investor:** 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 vary with the size of assets and the nature of the scheme.

There are 41 mutual funds in India, handling AUM worth Rs 1,187,477 Crore (as on March 31, 2015). There is scope for tremendous growth in size of the mutual fund industry in future and distributors can facilitate this growth.

### Summary

- Mutual funds offer an investment solution for investors who wish to invest in the financial markets but are unable to do so, because they do not have the requisite knowledge and / or time.
- Mutual funds offer schemes that collect money from investors and invest in the markets on their behalf.
- The profits or losses arising in a mutual fund scheme out of such investments belong to the investors in that scheme.
- The nature of investments that a scheme proposes to make is announced when the scheme is launched.
- Mutual funds offer several such schemes to cater to the needs of different types of investors.
- Mutual funds are closely regulated by Securities & Exchange Board of India (SEBI). SEBI (Mutual Funds) Regulations, 1996 sets out the regulatory framework.
- Association of Mutual Funds in India (AMFI) is an industry body constituted by mutual funds in the country.
- When a scheme is open for investment for a limited period, initially, it is called a New Fund Offer (NFO).
- Open-end schemes accept money from investors even after the NFO. Closed-end schemes don't.
- The investment that an investor makes in a scheme is translated into a certain number of 'Units' in the scheme.
- The purchase of units by the investor from the scheme is also called subscription. Refund of money to the investor by the scheme is called redemption.
- Under the law, every unit has a face value of Rs10. The number of units multiplied by its face value (Rs10) 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 or unrealised gains. Similarly, there can be valuation losses or unrealised losses, when securities are quoted in the market at a price below the cost at which the scheme acquired them.
- The practice of marking securities to their market value is called marked to market (MTM) valuation.

- The true worth of each unit of every scheme i.e. its Net Asset Value (NAV) is calculated based on MTM valuation of the investment portfolio. Thus, it captures all the gains and losses, realised and unrealised, besides interest and dividend income.
- MTM is the principal reason the NAV of the scheme fluctuates, even if there is no change in the investments held in the portfolio of the scheme.
- While NAV of mutual fund schemes fluctuate, the fluctuation is of little relevance to a long term investor; the investor's actual returns depend on the price at which he buys and sells the units of the scheme, and the dividend he earns from the scheme.
- Running the scheme entails costs viz. scheme running expenses. The expenses pull down the profits of the scheme and the NAV of the units.
- Options are offered within a scheme, to cater to the preferences of investors with respect to dividends.
- In a growth option, the scheme does not declare a dividend. So the entire investment performance is captured in its NAV.
- In a dividend option, the scheme declares a dividend from time to time. Since dividend comes out of net assets of the scheme, the NAV of the dividend option goes down after a dividend. This reduced NAV is called ex-dividend NAV.
- The dividend option can have two sub-options: dividend pay-out (where dividend is paid to the investor) and dividend re-investment (where dividend is declared but retained in the scheme. Instead of money, the investor is given new units against the dividend. The units are allotted at the ex-dividend NAV.
- Some investors prefer to invest directly i.e. without the assistance of distributors. Mutual fund schemes offer 'Direct' plans for the benefit of such investors. The NAV of the Direct plan is different from the NAV of the Distributor plan; in either case, the NAV is different for growth option and dividend option
- The relative size of mutual fund companies is evaluated by their assets under management (AUM). The AUM of a mutual fund is the sum of the AUM of all its schemes.
- The AUM captures the impact of scheme profitability and the flow of unit-holder money, to or from the scheme.
- Advantages of mutual funds include professional management, affordable portfolio diversification, economies of scale, liquidity, tax deferral, tax benefit on investment, choice of options, investment comfort, regulatory comfort and systematic approaches to investment.
- Limitations of mutual fund are lack of portfolio customisation, an overload of choices and no control over costs for the investor (within the SEBI limit).

- There are 41 mutual funds in India, handling AUM worth Rs 1,187,477 crore (as on March 31, 2015).

**Sample Questions**

- 1. Mutual funds offer an investment solution to investors -**
  - a. Who do not have the time
  - b. Who do not have the knowledge
  - c. Both (a) and (b)**
  - d. None of the above
  
- 2. Mutual Fund schemes are first offered to investors through:**
  - a. Initial Public Offer
  - b. New Fund Offer**
  - c. Stock Exchange
  - d. AMFI
  
- 3. NAV captures the impact of**
  - a. Realised gains and losses
  - b. MTM gains and losses
  - c. Both (a) and (b)**
  - d. None of the above
  
- 4. RGESS offers a rebate of \_\_\_\_\_ of investment upto \_\_\_\_\_**
  - a. 50%, Rs 50,000**
  - b. 50%, Rs100,000
  - c. 25%, Rs50,000
  - d. 20%, Rs100,000

## CHAPTER 2: FUND STRUCTURE AND CONSTITUENTS

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Structure and constitution of mutual funds
- Various types of entities/service providers associated with mutual funds
- Constituents of Asset Management Company

### 2.1 Legal Structure of Mutual Funds

The SEBI (Mutual Fund) Regulations, 1996 has laid down the structure for mutual funds in India as follows:

- Any mutual fund in India needs to be constituted in the form of a *Trust*.
- 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 by the sponsors. 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 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.
- The AMC 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.
- Mutual funds schemes in India are permitted to invest in securities (including equity shares and bonds / debentures), gold or gold related instruments and real estate assets. However, mutual fund schemes investing in real estate assets are yet to be launched.
- 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).

RTA's offices in various centres serve as *Investor Service Centres (ISCs)*, which perform a useful role in handling the documentation of investors.

Thus, the legal structure of mutual funds in India provides for various checks and balances to protect the investors. Let us understand the various agencies, by taking the example of the constitution of SBI Mutual Fund<sup>3</sup>.

<b>Mutual Fund Trust</b>	SBI Mutual Fund
<b>Sponsor</b>	State Bank of India
<b>Trustee</b>	SBI Mutual Fund Trustee Company Private Limited
<b>AMC</b>	SBI Funds Management Private Limited
<b>Custodian</b>	<ul style="list-style-type: none"><li>• HDFC Bank Limited, Mumbai</li><li>• SBI-SG Global Securities Pvt. Ltd.</li><li>• Bank of Nova Scotia (custodian for Gold)</li></ul>
<b>RTA</b>	Computer Age Management Services Pvt. Ltd

## 2.2 Other Service Providers

- 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.

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<sup>3</sup>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. Neither NISM nor the author recommends any market entity or any product discussed in this Workbook.

- Accounts of the schemes need to be maintained independent of the accounts of the AMC. The scheme's accounts are audited by an *auditor*, who needs to be different from the auditor of the AMC.
- *Distributors* have a key role in selling suitable types of units to their clients i.e. the investors in the schemes.
- 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.

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.

Leading collection bankers make it convenient to invest in NFOs of mutual fund schemes by accepting applications of investors in most of their branches.

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

<b>Service Provider</b>	<b>Support Function</b>
Fund Accountant	Calculate NAV ( in-house/outsource)
Auditor	Audit scheme's accounts
Distributors	Selling mutual fund scheme to investors
Collecting Banks	Collect investors' money

### 2.3 Organisation of AMC

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.
- *Securities Dealers* help in putting the transactions through in the market.

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- *Chief Marketing Officer (CMO)* is responsible for mobilizing money under various schemes. *Direct Sales Team* (generally focus on large investors), *Channel Managers* (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 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.

<b><u>Designation</u></b>	<b>Job Role</b>
CIO	Responsible for overall investments of the fund
<i>Securities Analysts</i>	Provide research inputs
<i>Securities Dealers</i>	Execute transactions
CMO	Responsible for mobilizing money under various schemes
COO	Handles all operations
Compliance Officer	Ensures legal compliance

### Summary

- Any mutual fund in India needs to be constituted in the form of a *Trust*.
- The mutual fund trust is created by one or more *Sponsors*, who are the main persons behind the mutual fund business.
- 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 by the sponsors.
- The Trust acts through its *trustees*. 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.
- Mutual funds schemes in India are permitted to invest in securities (including equity shares and bonds / debentures), gold or gold related instruments and real estate assets. However, mutual fund schemes investing in real estate assets are yet to be launched.
- 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.
- The record of investors and their unit-holding may be maintained by the AMC itself, or it can appoint a *Registrar & Transfer Agent (RTA)*.
- RTA's offices in various centres serve as *Investor Service Centres (ISCs)*, which perform a useful role in handling the documentation of investors.
- Accounts of the schemes need to be maintained independent of the accounts of the AMC.
- The scheme's accounts are audited by an *auditor*, who needs to be different from the auditor of the AMC.
- *Distributors* have a key role in selling suitable types of units to their clients i.e. the investors in the schemes.
- 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.

- AMC has the offices and employees to manage the day to day mutual fund operations. Operations of AMCs are headed by a Managing Director, Executive Director or Chief Executive Officer. Various business heads are appointed for diverse functions that need to be handled.
- As per SEBI regulations, every scheme requires a *fund manager*, though the same fund manager may manage multiple schemes.

**Sample Questions**

- 1. A mutual fund in India needs to be constituted as**
  - a. Trust
  - b. Company
  - c. Trustee company
  - d. Society
  
- 2. Day to day operations of the mutual fund are handled by**
  - a. RTA
  - b. ISCs
  - c. Board of Trustees
  - d. **AMC**
  
- 3. Mutual funds in India are permitted to invest in**
  - a. Securities
  - b. Securities and Gold
  - c. Securities other than real estate
  - d. **Securities, gold and real estate**
  
- 4. Investments of a mutual fund scheme are held by**
  - a. **Custodian**
  - b. Board of Trustees
  - c. AMC
  - d. RTA

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## CHAPTER 3: MUTUAL FUND PRODUCTS

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Mutual fund schemes based on their organisation structure—open ended, close ended and interval funds.
- Mutual fund schemes based on their investment style—active and passive
- Mutual fund schemes based on their portfolio—equity, debt, hybrid
- Gold Funds—ETFs, sector funds, saving funds

Schemes can be classified in various ways, depending on how they are structured and the nature of investments they make.

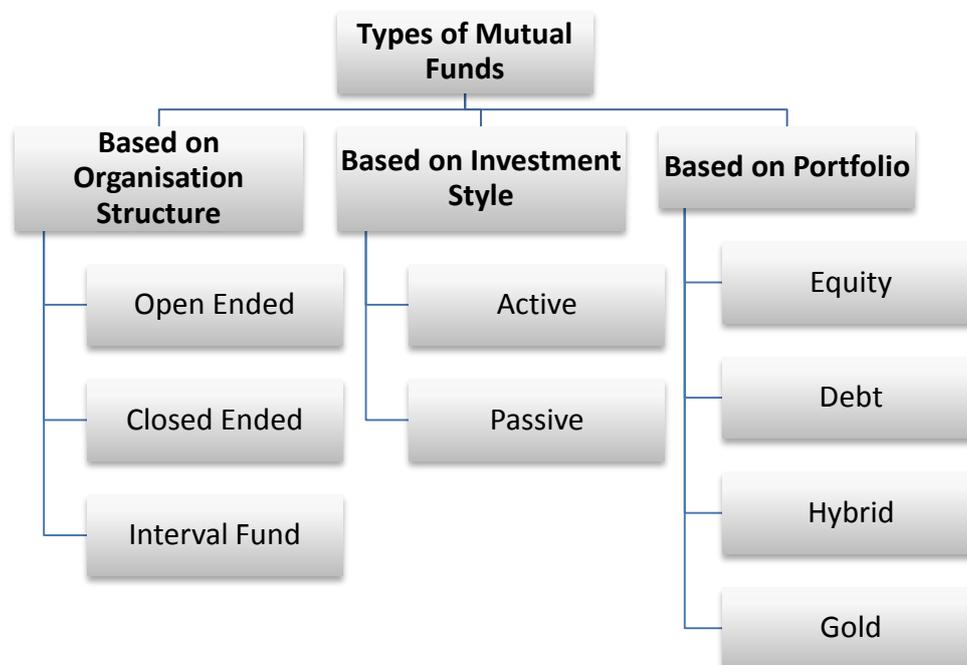


Figure: Types of Mutual Funds

### 3.1 Open-end, Closed-end and Interval Funds

AMCs launch NFOs (New Fund Offer) and collect investor's money in a freshly launched mutual fund scheme. After the NFO period is over, some schemes allow investors to put in fresh money while other schemes do not.

*Open-end schemes* are open for investors to enter or exit at any time, even after the NFO.

When existing investors buy additional units or new investors buy units of the open-end scheme, it is called a *sale transaction* (or *subscription*). It happens at a *sale price*, which is equal 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* (or *redemption*). This happens at a *re-purchase price* (i.e. *redemption price*) that is linked to the NAV.

Although some unit-holders may exit from the open-end 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.

Continuous entry and exit of investors implies that the unit capital in an open-ended fund would keep changing on a regular basis.

*Closed-end funds* have a fixed maturity. Investors can buy units of a closed-end scheme, from the fund, only during its NFO. The fund makes arrangements for the units to be traded, post-NFO in the stock exchange/s. This is done through a listing of the scheme in one or more stock exchanges. Such listing is compulsory for closed-end schemes.

After the NFO, investors who want to buy units of a closed-end fund will have to find a seller for those units in the stock exchange. Similarly, investors who want to sell units of a closed-end fund will have to find a buyer for those units in the stock exchange. This is done through the screen-based trading system of the stock exchange (as in the case of shares).

Transactions in the stock exchange need to be effected through members (brokers) in a stock exchange, and may call for a demat account<sup>4</sup> in the name of the investor.

*Interval funds* combine features of both open-end and closed-end schemes. They are largely closed-end, but become open-end during pre-specified time periods.

For instance, an interval scheme might become open-end between January 1 to 15, and July 1 to 15, each year. The benefit for investors is that, unlike in a purely closed-end scheme, they are not completely dependent on the stock exchange to be able to buy or sell units of the interval fund. There is a *transaction period* (January 1 to 15 and July 1 to 15, in this example), when both subscription and redemption may be made to and from the scheme). Transaction period has to be of minimum 2 working days, as per SEBI Regulations.

The gap between two successive transaction periods (January 15 to July 1, in this example) is called *interval period*. The minimum duration of an interval period is 15 days. Subscription and redemption is not permitted during the interval period.

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<sup>4</sup>Demat account is an account where securities owned by the investor are held (just as a bank account holds the moneys of the depositor). It helps investors in holding their securities in electronic form.

The new cadre of distributors can sell open-end, closed-end and interval schemes, subject to the limitations mentioned elsewhere in this Chapter.

### 3.2 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 fund* invests on the basis of a specified index, whose performance it seeks to track. Thus, a passive fund, tracking the CNX Nifty<sup>5</sup> or S&P BSE Sensex<sup>6</sup>, would buy only the shares that are part of the composition of that index. 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 index.

Therefore, the performance of these funds tends to mirror the concerned index. Yet, there are gaps in the performance of these funds as compared to the index. This gap in performance is its *tracking error*. It can be positive or negative i.e. the passive fund performance can be better or worse than the concerned index, for various reasons.

Passive funds are not designed to perform better than the market. On account of linkage to the index, they 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.

The index, on which a passively managed scheme is constructed, is called its *benchmark*. Similarly, even active schemes have a benchmark – a standard against which scheme performance can be compared. A benchmark is announced when every scheme, active or passive, is launched.

*Exchange traded funds* (ETFs) are a type of open-end index fund that are listed in the stock exchange. Investors need a demat account for buying units of ETF. Post-NFO, retail investors can transact in ETF units only in the stock exchange.

The new cadre of distributors can sell both actively managed and passive schemes, subject to the limitations mentioned elsewhere in this Chapter.

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<sup>5</sup>An equity market index constructed on the basis of 50 shares traded on the National Stock Exchange

<sup>6</sup>An equity market index constructed on the basis of 30 shares traded on the Bombay Stock Exchange

### 3.3 Equity, Debt & Hybrid Funds

A scheme might have an investment objective to invest largely in equity shares and equity-related investments like convertible debentures<sup>7</sup>. Such schemes are called *equity schemes*.

Schemes with an investment objective that limits them to investments in debt securities like Treasury Bills<sup>8</sup>, Government Securities, Bonds and Debentures are called *debt funds* or *income funds*.

*Hybrid funds* have an investment charter that provides for a reasonable level of investment in both debt and equity.

The new cadre of distributors can sell specific types of equity and debt schemes detailed in the next two sections. However, they cannot sell hybrid funds.

### 3.4 Types of Equity Funds

*Diversified equity fund* is a category of equity funds that invest in a diverse mix of equities that cut across sectors (such as banking, pharma, etc.). They may be managed actively or passively. The RGESS tax benefit discussed in Chapter 1 is available only for diversified equity schemes that invest in companies, which fulfil specified criteria. Such schemes are sold in the market as RGESS schemes.

*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.

*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.

*Equity Linked Savings Schemes (ELSS)*, as seen in Chapter 1, offer income tax benefits to investors. However, the investor cannot sell the Units for at least 3 years. ELSS schemes invest in a range of sectors.

*Equity Income / Dividend Yield Schemes* invest in multiple sectors. They select shares that fluctuate less, and therefore, dividend represents a larger proportion of the returns earned by the scheme from those shares. The NAV of such equity schemes are expected to fluctuate lesser than other categories of equity schemes.

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<sup>7</sup>Convertible Debentures are debentures that are convertible into a certain number of equity shares of the company

<sup>8</sup>Treasury Bills are issued by Reserve Bank of India. They mature within a year.

The new cadre of distributors can only sell diversified equity schemes. Sector funds and thematic funds are therefore not permitted to be sold by them.

### **3.5 Types of Debt Funds**

*Gilt funds* invest in only treasury bills and government securities (such as those issued by Reserve Bank of India or Government of India), which do not have a credit risk. Credit risk means the risk that the issuer of the security defaults in repayment.

*Diversified debt funds* on the other hand, invest in a mix of government and non-government debt securities.

*Fixed maturity plans (FMPs)* 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. Under the regulations, FMPs need to be structured as closed-end scheme. Thanks to these characteristics, the fund manager has little ongoing role in deciding on the investment options in FMPs.

Such a portfolio construction gives more clarity to investors on the likely returns if they stay invested in the scheme until its maturity. This helps them compare the returns with alternative investments like bank deposits. However, the returns in a FMP are subject to market risk until they mature. Further, on maturity, the issuer may not be in a position to pay the redemption amount i.e. there is a credit risk too.

Every FMP is a closed-end debt fund; however, every closed-end debt fund is not a FMP. In closed-end debt funds that are not FMP, the fund manager keeps shuffling the debt portfolio in line with changes in the market. Therefore, the returns from non-FMP closed-end debt funds are more unpredictable than the returns from FMP.

*Liquid schemes or money market funds* are a variant of debt schemes that invest only in debt securities where the moneys will be repaid within 91 days. These are widely recognized to be the lowest in risk among all kinds of mutual fund schemes.

The new cadre of distributors can only sell FMP, out of the products discussed above.

### **3.6 Types of Hybrid Funds**

*Monthly Income Plan (MIP)* seeks to declare a dividend every month, though the dividend is not guaranteed. It invests largely in debt securities. However, a small percentage is invested in equity shares to improve the scheme's yield.

*Capital Protection Oriented Schemes* are closed-end schemes, which are structured to ensure that investors get their principal back, irrespective of what happens to the market. This is ideally done by making adequate investment in Government Securities. The remaining corpus is invested in the market.

Even if the market-based 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 capital protection oriented schemes offer the capital protection through complex portfolio optimisation strategies that dynamically hedge the portfolio.

Some schemes of this type are structured differently. 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, there is an element or risk of loss of principal in funds structured in this manner.

The new cadre of distributors are not allowed to sell hybrid schemes.

### 3.7 Gold Funds

Gold funds invest in gold and gold-related securities.

**Gold Exchange Traded Fund (Gold ETF)** is like an open-end index fund that invests in gold. The NAV of such funds moves in line with gold prices in the market, though some tracking error is possible. Investors need a demat account for buying units of Gold ETF. Post-NFO, retail investors can transact in ETF units only in the stock exchange.

**Gold Funds** (also called *Gold Savings Funds*) invest in Gold ETF units. They are costlier than the Gold ETF.

Unlike Gold ETF, Gold funds make it possible for retail investors to transact in the units, directly with the scheme, even post-NFO. Further, since SIP is possible, and the investor does not need a demat account, Gold Funds are quite popular among retail investors.

**Gold Sector Funds** 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.

### Summary

- Open-end schemes are open for investors to enter or exit at any time, even after the NFO.
- When existing investors buy additional units or new investors buy units of the open-end scheme, it is called a *sale transaction* (or *subscription*). It happens at a *sale price*, which is equal 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* (or *redemption*). This happens at a *re-purchase price* (or *redemption price*) that is linked to the NAV.
- Closed-end funds have a fixed maturity. Investors can buy units of a closed-end scheme, from the fund, only during its NFO. Thereafter, they can be transacted in the stock exchange.
- *Interval funds* combine features of both open-end and closed-end schemes. They are largely closed-end, but become open-end during pre-specified time periods.
- *Transaction period* for an interval fund has to be of minimum 2 working days, as per SEBI Regulations.
- The gap between two successive transaction periods i.e. the interval period has to be of minimum duration of 15 days.
- *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.
- *Passive fund* invests on the basis of a specified index, whose performance it seeks to track. Such funds are also called *index funds*. These have low running costs.
- There are gaps in the performance of index funds as compared to the index. This gap in performance is their tracking error.
- The index on which a passively managed scheme is constructed, is called its *benchmark*. Similarly, even active schemes have a benchmark – a standard against which scheme performance can be compared.
- A scheme might have an investment objective to invest largely in equity shares and equity-related investments like convertible debentures. 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* or *income funds*.
- *Hybrid funds* have an investment charter that provides for a reasonable level of investment in both debt and equity.

- *Diversified equity fund* is a category of equity funds that invest in a diverse mix of equities that cut across sectors. They may be managed actively or passively.
- *Sector funds* invest in only a specific sector.
- *Thematic funds* invest in line with an investment theme.
- *Equity Income / Dividend Yield Schemes* invest in multiple sectors. They select shares that fluctuate less, and therefore, dividend represents a larger proportion of the returns earned by the scheme from those shares.
- *Gilt funds* invest in only treasury bills and government securities, which do not have a credit risk.
- *Diversified debt funds* invest in a mix of government and non-government debt securities.
- *Fixed maturity plans (FMPs)* are a kind of debt fund, where the investment portfolio is closely aligned to the maturity of the scheme. Their portfolio construction gives more clarity to investors on the likely returns if they stay invested in the scheme until its maturity. This helps them compare the returns with alternative investments like bank deposits. However, the returns in a FMP are subject to market risk until they mature, and credit risk too.
- *Liquid schemes or money market funds* are a variant of debt schemes that invest only in debt securities where the moneys will be repaid within 91-days. These are widely recognized to be the lowest in risk among all kinds of mutual fund schemes.
- *Monthly Income Plan* seeks to declare a dividend every month, though the dividend is not guaranteed. It invests largely in debt securities.
- *Capital Protection Oriented Schemes* are closed-end schemes, which are structured to ensure that investors get their principal back, irrespective of what happens to the market.
- *Gold Exchange Traded Fund (Gold ETF)* is like an open-end index fund that invests in gold.
- *Gold Funds* (also called *Gold Savings Funds*) invest in Gold ETF units. They are costlier than the Gold ETF.
- Gold funds make it possible for investors to transact in the units, directly with the scheme, even post-NFO. Further, SIP / SWP / STP is possible and demat account is not required.
- *Gold Sector Funds* invest in shares of companies engaged in gold mining and processing.

**Sample Questions**

- 1. Investors can enter and exit \_\_\_\_\_ at any time**
  - a. Open-end schemes**
  - b. Closed-end schemes
  - c. Fixed Maturity Plan
  - d. Interval Fund
  
- 2. Investor buying a unit from the scheme is called a \_\_\_\_\_ transaction.**
  - a. Re-purchase
  - b. Redemption
  - c. Sale**
  - d. None of the above
  
- 3. Tracking error of index schemes is always**
  - a. Positive
  - b. Negative
  - c. Zero
  - d. None of the above**
  
- 4. \_\_\_\_\_ is lowest in risk**
  - a. Liquid funds**
  - b. Gilt funds
  - c. Fixed maturity plans
  - d. Diversified equity funds

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## CHAPTER 4: PERFORMANCE OF MUTUAL FUNDS

### LEARNING OBJECTIVES:

After studying this chapter, you should know:

- How to calculate returns of a mutual fund scheme
- How to calculate returns for an investor investing in mutual fund scheme
- The concept of risks adjusted returns measurement—Sharpe and Treynor ratio
- Concept of benchmark comparison in case of mutual funds

### 4.1 Scheme Returns

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:

$$\frac{(\text{End Value} \textit{ minus } \text{Begin Value}) \times 100}{\text{Begin Value}}$$

$$\frac{(\text{Rs } 15 - \text{Rs } 12) \times 100}{\text{Rs } 12}$$

i.e. **25%**

If the return related to a period not equal to 12 months, then the *annualized return* can be calculated as:

$$\frac{\text{Simple Return} \times 12}{\text{Period of Simple Return (in months)}}$$

Thus, if the 25% return related to 8 months, annualised return can be calculated to be  $(25\% \times 12) \div 8$  i.e. 37.50%.

These calculations are valid when the investment holding period is less than 1 year. During longer periods of time, the calculations need to be adjusted to consider the effect of compounding.

Further, the scheme may have declared dividends, which bring down the ex-dividend NAV. If the dividend is not considered in the return calculations, then the results will be misleading on account of under-statement of return.

Mutual funds declare *Compounded Annual Growth Rate (CAGR)* which provides for compounding and dividend payments. CAGR is the SEBI-accepted method of declaring scheme returns, when the period is more than a year.

### 4.2 Investor Returns

If the investor invested at the NAV and redeemed his investments at the NAV, then the scheme returns for any period will be equal to the investor's returns for the same period.

At the NFO stage, investors invest at the face value of Rs10, in the case of both open-end and closed-end schemes.

They invest in the post-NFO stage in closed-end schemes at the prevailing price in the stock exchange.

Their post-NFO investment in open-end schemes is done at the Sale Price.

Earlier, open end schemes could fix the Sale Price higher than NAV. The difference was called *entry load*. For example, if NAV was Rs 15, and the scheme declared Sale Price of Rs 15.30, the differential of Rs 0.30 was entry load. Under the current regulatory environment, entry load is not permitted. Therefore, investors subscribe to units of open-end schemes at the NAV.

Investors can sell their units held in closed-end schemes, at the prevailing market price.

They can redeem their units held in open-end schemes, at the Re-purchase Price, which can be lower than NAV. The difference is called *exit load*. For example, if NAV is Rs 15 and the scheme declares Re-purchase Price of Rs. 14.75, the differential of Rs 0.25 is exit load.

SEBI regulations permit exit load upto 7% of NAV. In practice, the load is much lower.

Further, the load may be higher for shorter holding periods, and may not be charged for longer holding periods. Such structures are called Contingent Deferred Sales Load (CDSL).

Net of service tax, the exit load is put back in the scheme. Thus, an investor exiting from the scheme bears the load, but it benefits other investors who continue in the scheme.

Exit load (if any) is mentioned in the Offer Document for the scheme. Public announcement is made for any change in the load structure; such change will be applicable on only fresh subscriptions made by the investors in the open-end scheme after the change is notified. The exit load that is effective at the time of subscription is applicable whenever the investor redeems those units.

For example, if the exit load is changed from 0.5% to 0.75% with effect from December 1, 2012. All investors who invested upto November 30, 2012 will bear an exit load of 0.5% on the NAV, irrespective of when they offer their units for re-purchase. Investors who invest from December 1, 2012 will bear an exit load of 0.75% on the prevailing NAV when they offer their units for re-purchase.

Investor's returns from a scheme for any period will be lower than the scheme returns for the same period, to the extent of the load that is charged.

Another point to note is that the investor's returns are primarily driven by the portfolio. Appreciation in portfolio value causes the NAV to go up, which translates into returns for the investor.

Therefore, the change in NAV (and dividend, if any) is important for the investor – not the absolute value of NAV. If two similar schemes have NAVs of Rs 12 and Rs 15 respectively, it does not mean that the latter is costlier and therefore less worthy of investment.

An appreciation in NAV from Rs 12 to Rs 20 in the first scheme implies a return of  $(Rs\ 8 \div Rs\ 12) \times 100$  i.e. 66.7%. The second scheme's NAV can go up from Rs 15 to Rs 30 to give a 100% return for the investor, although the initial investment per unit is higher.

Investors need to take a call on the likely appreciation in the portfolio, without getting the judgment clouded by the absolute value of NAV.

### 4.2.1 Total Returns

Mutual funds can offer returns in two forms; capital gains or losses and dividend. Total return can be positive or negative.

For example, Ashish invested in an equity mutual fund Rs. 1 lakh, at NAV of Rs. 10. He was allotted 10,000 units. The scheme declared dividend of Rs. 2. The current NAV of the scheme is Rs. 12. Calculate the total return on investment?

$$\text{Total Return} = \frac{(\text{End Value} - \text{Begin Value}) + \text{Dividend} * 100}{\text{Begin Value}}$$

Begin value = Rs 1,00,000

End Value = Rs 12 \* 10,000 units = Rs. 1,20,000

Dividend = Rs. 2 \* 10000 units = Rs. 20,000

$$\begin{aligned} \text{Total Return} &= \frac{(1,20,000 - 1,00,000) + 20,000}{1,00,000} * 100 \\ &= \frac{40,000}{1,00,000} * 100 \end{aligned}$$

**Total Return = 40%**

### 4.2.2 Compound Return

Total return is a comprehensive measure of returns because it takes into account all the benefits earned from an investment. However, the time taken to generate returns should also be given due importance. In the earlier example, the total return of 40% looks attractive but if the initial investment was made 5 years ago, will this investment still be considered as a good investment option? Hence, total return may not be appropriate measure of return especially for periods greater than a year.

To calculate long term returns, we can use CAGR i.e. Compounded Annualized Growth Rate. We can easily understand CAGR returns by comparing it with simple interest calculation.

Below we have calculated simple interest return and CAGR return on an investment of Rs. 10 lakhs generating 8% returns p.a. for a period of 5 years.

Returns based on Simple Interest				
Years	Initial Investment	Rate of Interest	Interest reinvested	Value at end of the year
Year 1	1,00,000	8%	8,000	1,08,000
Year 2	-	8%	8,000	1,16,000
Year 3	-	8%	8,000	1,24,000
Year 4	-	8%	8,000	1,32,000
Year 5	-	8%	8,000	<b>1,40,000</b>

Returns based on Compound Interest or CAGR				
Years	Initial Investment	Rate of Interest	Interest reinvested	Value at end of the year
Year 1	1,00,000	8%	8,000	1,08,000
Year 2	-	8%	8,640	1,16,640
Year 3	-	8%	9,331	1,25,971
Year 4	-	8%	10,078	1,36,049
Year 5	-	8%	10,884	<b>1,46,933</b>

The reason for the difference in end value of investment after 5 years is the way returns are calculated. When an investment generates simple interest, the return is earned only on the initial investment every single year. However, in case of CAGR method the interest / return earned during a period is added back to the principal amount. As a result, interest is reinvested in the asset so that interest is earned on interest.

The impact on returns due to compounding may be marginal in the initial years but for longer periods the positive difference in returns could be jaw dropping.

### **4.3 Risks**

Risk is defined as deviation from expectation i.e. what is actually earned as return could be different from what is expected to be earned. Deviations from expected outcomes can be positive or negative; both are considered as risky. However, it is human nature to focus on negative deviations.

Since mutual fund schemes invest in the markets, the return they will earn is unpredictable. As discussed in the previous chapter, only in the case of FMP, the unpredictability can be controlled to an extent.

In the market, such risk is commonly quantified through two measures, Standard Deviation and Beta. Standard Deviation is the average deviation of observed returns from the average return over a time period. It is a measure of dispersion, since it measures the extent to which observed values are scattered away from the average. Beta is a measure of volatility of a security or portfolio in comparison to the market as a whole. The higher the value of these measures for a scheme, more risky the scheme is.

For example, if the standard deviation of two schemes is 1.1 and 1.2 respectively, the latter scheme is considered riskier. Similarly, the scheme with the higher beta is considered more risky.

Debt securities trade in the market based on yields prevailing for similar securities. When yields rise in the market, the values of debt securities fall and vice versa (although the issuer of the debt security has to pay the same fixed rate of interest periodically).

For example, if an issuer has issued a debenture offering 9% fixed rate of interest. If yields for similar instruments in the market were to go up subsequently, then the 9% fixed rate on the debenture becomes less attractive; its value will fall in the market. Similarly, if yields for similar debentures were to fall in the market, the 9% debenture will appreciate in value in the market.

For the same change in debt market yields, value of debt securities that have a longer time to maturity tend to change more than those with shorter time to maturity. Therefore, the longer tenor securities are said to have a greater *market risk* or *price risk*.

Modified duration and weighted average maturity are two indicators of the price risk in a debt security / debt scheme. Higher the number (value of modified duration and weighted average maturity), more is the price risk in a debt portfolio.

For example, if two debt schemes have weighted average maturity of 1.2 and 3.5 respectively, the latter will fluctuate more in response to the same change in yields in the market. The risk is therefore higher in the latter scheme. Similarly, the debt scheme with higher modified duration has greater price risk.

Some debentures are issued on the basis that the interest payable on them floats with the market. For example, a debenture may promise interest at the Treasury Bill Rate + 2%. Thus,

if the Treasury Bill Rate (which is determined by market forces) is 6%, the debenture pays 8% interest; if the Treasury Bill Rate goes up to 8%, the debenture pays a higher interest of 10%. This kind of interest structure is called floating rate (in contrast to the (9%) fixed rate discussed earlier).

Since the interest that the issuer pays on the floating rate debenture keeps getting adjusted in response to changes in yields in the market, the value of the debenture remains steady. Thus, price risk is controlled in floating rate debentures.

Mutual fund schemes that primarily invest in floating rate debentures are called floating rate schemes or floaters.

When the price of the debt securities that a scheme has invested in rises (or falls), the scheme NAV too will rise (or fall) as discussed in Chapter 1. Besides price risk, debt securities (and therefore schemes that invest in those securities) are exposed to many other risks. Credit risk is one such risk. This is the risk that the issuer does not pay the promised interest or redemption amount. As discussed in Chapter 3, gilt funds do not have the credit risk.

#### 4.4 Risk-adjusted Returns

Investments need to be made by balancing the risk and return. Measures of scheme performance that consider both risk and return are called *risk-adjusted returns*. Two such measures that one often encounters in the market are *Sharpe Ratio* and *Treynor Ratio*. Sharpe ratio relates the excess return generated by an investment to the standard deviation. Treynor ratio compares the excess return generated by an investment to Beta. The higher the value of these measures, the better is considered to be the scheme performance in terms of risk-adjusted returns.

For example, if liquid fund A has Sharpe Ratio of 1.2 and liquid fund B has Sharpe Ratio of 1.3, then B is considered to be a better performer than A. Similarly, the scheme with higher Treynor Ratio is considered to be the better performer.

Such comparison is to be done only between schemes of the same type. For example, it would be wrong to compare the Sharpe Ratio of an equity scheme, with the Sharpe Ratio of a debt scheme.

The market also discusses the alpha of schemes. Alpha is a measure of the value that the fund manager brought to the equity scheme performance. Higher the alpha value for an equity scheme, better is considered to be the risk-adjusted performance of the fund manager.

#### 4.5 Scheme Comparison to Benchmark

The concept of benchmark was introduced in the previous chapter. It is some standard against which the scheme performance can be compared.

A scheme that has performed better than its benchmark is said to have out-performed. Some schemes do under-perform i.e. demonstrate a performance that is weaker than the benchmark.

Some benchmarks that are commonly used in the industry are as follows:

<b>Sl. No.</b>	<b>Benchmark</b>	<b>Relevant for (Type of scheme)</b>	<b>Published by</b>
1	CNX Nifty	Diversified equity	National Stock Exchange
2	S&P BSE Sensex	Diversified equity	Bombay Stock Exchange
3	Mumbai Inter-bank Offered Rate (MIBOR)	Liquid	National Stock Exchange
4	Liquid Fund Index (Liquifex)	Liquid	Crisil.com
5	Composite Bond Fund Index (Compbex)	Income / Debt	Crisil.com
6	Balanced Fund Index (Balance Ex)	Balanced	Crisil.com
7	MIP Index (MIPEX)	MIP	Crisil.com
8	Short Maturity Gilt Index (Si-BEX)	Gilt schemes of short maturity	ICICI Securities
9	Medium Maturity Gilt Index (Mi-BEX)	Gilt schemes of medium maturity	ICICI Securities
10	Long Maturity Gilt Index (Li-BEX)	Gilt schemes of long maturity	ICICI Securities
11	Composite Gilt Index	Composite gilt schemes	ICICI Securities

The new cadre of distributors is permitted to sell only 'performing schemes'. SEBI has defined 'performing schemes' as those that have performed better than the benchmark in each of the previous three financial years.

## Summary

- The *Simple Return* can be calculated with the following formula:

$$\frac{(\text{End Value} \textit{ minus } \text{Begin Value}) \times 100}{\text{Begin Value}}$$

- If the return related to a period not equal to 12 months, then the *annualized return* can be calculated as:

$$\frac{\text{Simple Return} \times 12}{\text{Period of Simple Return (in months)}}$$

- During periods longer than a year, return calculations need to be adjusted to consider the effect of compounding.
- Dividend options in any scheme may have declared dividends, which bring down the ex-dividend NAV. If the dividend is not considered in the return calculations, then the results will be misleading on account of under-statement of return.
- Mutual funds declare *Compounded Annual Growth Rate (CAGR)* which provides for compounding and dividend payments. CAGR is the SEBI-accepted method of declaring scheme returns, when the period is more than a year.
- In CAGR, the return earned during a period is added back to the principal amount. As a result, interest is reinvested in the asset so that interest is earned on interest.
- Earlier, open end schemes *could fix the Sale Price higher than NAV*. The difference was called *entry load*.
- Investors can redeem their units held in open-end schemes, at the Re-purchase Price, which can be lower than NAV. The difference *is called exit load*.
- SEBI regulations permit exit load upto 7% of NAV. In practice, the load is much lower.
- The exit load may be higher for shorter holding periods, and may not be charged for longer holding periods. Such structures are called *Contingent Deferred Sales Load (CDSL)*.
- Net of service tax, the exit load is put back in the scheme. Thus, an investor exiting from the scheme bears the load, but it benefits other investors who continue in the scheme
- Investor's returns from a scheme for any period will be lower than the scheme returns for the same period, to the extent of the load that is charged.
- Investors need to take a call on the likely appreciation in the portfolio, without getting the judgment clouded by the absolute value of NAV.
- In the market, risk is commonly quantified through two measures, *Standard Deviation* and *Beta*. The higher the value of these measures for a scheme, more risky the scheme is.

- Standard Deviation is the average deviation of observed returns from the average return over a time period.
- Beta is a measure of volatility of a security or portfolio in comparison to the market as a whole.
- Debt securities trade in the debt market based on yields prevailing for similar securities. When yields rise in the market, the values of debt securities fall and vice versa.
- For the same change in debt market yields, value of debt securities that have a longer time to maturity tend to change more than those with shorter time to maturity. Therefore, the longer tenor securities are said to have a greater price risk.
- *Modified duration* and *Weighted average maturity* are two indicators of the price risk in a debt security / debt scheme. Higher the number, more is the price risk in a debt portfolio.
- Some debentures are issued on the basis that the interest payable on them floats with the market. This kind of interest structure is called *floating rate*.
- Mutual fund schemes that primarily invest in floating rate debentures are called *floating rate schemes* or *floaters*.
- Measures of scheme performance that consider both risk and return are called *risk-adjusted returns*. Two such measures that one often encounters in the market are *Sharpe Ratio* and *Treynor Ratio*. The higher the value of these measures, the better is considered to be the scheme performance in terms of risk-adjusted returns.
- Comparison is to be done only between schemes of the same type. For example, it would be wrong to compare the Sharpe Ratio of an equity scheme, with the Sharpe Ratio of a debt scheme.
- *Alpha* is a measure of the value that the fund manager brought to the equity scheme performance. Higher the alpha value for an equity scheme, better is considered to be the risk-adjusted performance of the fund manager.
- A scheme that has performed better than its benchmark is said to have *out-performed*. Some schemes do *under-perform* i.e. demonstrate a performance that is weaker than the benchmark.
- SEBI has defined '*performing schemes*' as those that have performed better than the benchmark in each of the previous three financial years.

**Sample Questions**

1. NAV of growth option of a scheme went up from Rs 10 to Rs 12. Simple return on the scheme is
  - a. 2%
  - b. 20%**
  - c. 1.2%
  - d. 12%
  
2. Which of the following considers compounding?
  - a. Simple return
  - b. Annualised return
  - c. CAGR**
  - d. None of the above
  
3. Investor's return is different from scheme return to the extent of
  - a. Load**
  - b. Scheme running expenses
  - c. MTM
  - d. AMC fees
  
4. \_\_\_\_\_ is a measure of risk-adjusted return
  - a. Simple return
  - b. Standard Deviation
  - c. Beta
  - d. Sharpe Ratio**

## CHAPTER 5: MUTUAL FUNDS TAXATION

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Different types of taxes associated with mutual funds schemes
- Different types of taxes levied on the mutual fund investors—STT, Capital Gains Tax and Dividend Distribution Tax
- Selecting different schemes of mutual funds based on their tax implication.

### 5.1 Taxation of Mutual Fund Schemes

Mutual fund schemes do not pay a tax on their capital gains or losses. Similarly, they do not pay tax on their net income i.e. income *minus* expenses. However, schemes incur Securities Transaction Tax (STT) on their equity market related transactions.

When a debt scheme distributes dividend to its unit-holders, it has to pay an Additional Tax of Income Distribution (in the market it is commonly referred to as “Dividend Distribution Tax” or DDT). Since the tax payment reduces the NAV, scheme returns are affected. This is an indirect cost for the unit holder.

The dividend that the unit-holder receives is however exempt from tax in the case of both equity and debt schemes.

For example, if the debt scheme distributed dividend of Re 1 per unit and the DDT is 28.325%, then the scheme will pay Rs 0.28325 to the income tax authorities. The Re 1 per unit received by the investor is tax-free in his hands. However, the NAV will go down by Rs 1 (dividend that he received) plus Rs 0.28325 (paid to income tax authorities) i.e. by Rs 1.28325. Thus, a dividend declaration of Rs 1.28325 becomes a dividend receipt of Rs1 (which is tax-free in the hands of the investor).

The DDT, that the scheme will pay the Income Tax authorities, for every Rs 100 distributed as dividend to the unit-holders, is as follows:

Scheme Type	Investor Type	Tax
<i>Equity Schemes</i>	All	Nil
<i>Debt Schemes</i>	Individuals & HUF	28.84% (25% + 12% surcharge + 3% Cess)
	Other Investors	34.608% (30% + 12% Surcharge + 3% Cess)

## 5.2 Taxation of Investors in Schemes

### 5.2.1 Securities Transaction Tax (STT)

When an investor sells units of an equity fund in the stock exchange, or offers them for re-purchase to the fund, he will have to incur STT of 0.001% on the value of the transaction.

For example, if the value of the sale of units of an equity fund is Rs 1000, the broker will charge STT of 1 paise in the contract note. Thus, the investor will receive Rs 1000 – Rs 0.01 i.e. Rs 999.99. Similarly, mutual funds also pay STT on the securities bought or sold by them at 0.10%.

STT is not applicable on purchase of units of an equity scheme from the fund or the stock exchange. It is also not applicable to transactions in debt securities or debt mutual fund schemes. However, STT is applicable at 0.001% on sale of units of equity oriented mutual funds whether sold on stock exchange or otherwise.

Securities Transaction Tax	
Transaction	STT Rate
Purchase of units of equity oriented mutual funds on stock exchange	Nil
Sale of units of equity oriented mutual fund	0.001%
Sale of units of equity oriented mutual fund on stock exchange	0.001%
Sale of units other than equity oriented mutual fund	Nil
Mutual Funds pay STT wherever applicable on the securities bought or sold at 0.10%	

### 5.2.2 Capital Gains Tax

If a unit-holder buys a mutual fund unit (from the scheme or the market) at Rs 12 and sells it in the market or offers it to the scheme for re-purchase at Rs 15, the difference of Rs 15 – Rs 12 i.e. Rs 3 is treated as capital gain.

In case of equity schemes, the units held for more than a year, are classified as a long-term capital asset or else they are short-term capital asset.

In case of non-equity based mutual funds, units held for a period of more than three years are classified as long term asset.

The tax treatment on capital gains in the hands of the investor is based on three aspects;

- a. Period of holding – Short term or long term
- b. Type of scheme – equity mutual funds or other schemes
- c. Owner of scheme – whether individual or company

Taxability of capital gains in the hands of the investor is as follows:

Types of Mutual Fund Schemes	Capital Gain Type	For Individuals	For Companies
Equity Scheme	Long Term Gains	Nil	Nil
	Short Term Gains	15% + 3% cess	15% + 3% cess
Other Schemes	Long Term Gains	20% with indexation + 3% cess	20% with indexation + 3% cess
	Short Term Gains	As per applicable tax slab + 3% cess	30% + 3% cess

The unit-holder pays tax on capital gains from equity schemes, only if the units are held for less than 1 year at the rate of 15%. If the units of equity schemes are held for more than 1 year then tax on capital gains is Nil.

In the case of other schemes, if the unit-holder holds the units for less than 3 years, the capital gain is added to the taxable income of the unit-holder. A unit-holder whose taxable income (including the capital gain) is below the taxable limit will not have to pay tax on such short term gains from non-equity schemes. Unit-holders with higher income will have to pay tax at 10%, 20% or 30%, depending on the tax slab applicable. However, companies have to pay tax at a standard rate of 30% on short term gains made on schemes other than equity mutual funds.

The government announces a cost inflation index number every financial year. This is used for determining taxability of long term capital gains in non-equity schemes.

Suppose the investor invested in mutual fund units at Rs 11 per unit in a financial year for which cost inflation index is 500. He sells the units at Rs 14 per unit after holding them for more than three years. In the year of sale, the cost inflation index is 600.

Since the holding is for more than three years, it is a long term capital gain. In the case of long term capital gain, investors in non-equity mutual fund schemes are allowed to increase their cost of acquisition to the extent of inflation. This inflation-adjusted cost of acquisition of units in the above case would be  $\text{Rs } 11 \times 600 \div 500$  i.e. Rs.13.20 per unit.

While the actual capital gains of the investor are Rs 14 *minus* Rs 11 i.e. Rs3 per unit, the capital gains based on inflation adjusted cost is only Rs 14 *minus* Rs 13.20 per unit i.e. Rs 0.80 per unit. Tax is to be calculated on the inflation-adjusted capital gain at 20%. This works out to Rs  $0.80 \times 20\%$  i.e. Rs 0.16 per unit. Therefore, the investor will pay long term capital gains tax at Rs0.16 per unit.

The capital gains tax, if applicable, is not deducted by the scheme when paying the re-purchase proceeds to investors who are resident in India. Similarly, it is not deducted by the broker when the resident investor sells units of closed-end scheme in the stock exchange. The investor has to pay the capital gains tax to the income tax authorities on self-assessment basis.

In the case of investors who are not resident in India, the scheme may pay the net re-purchase proceeds after making a deduction for Withholding tax.

### **5.2.3 Additional Tax on Income Distributed (DDT)**

As discussed earlier, dividend received by the investor is tax-free in his hands. However, non-equity funds pay a tax on the dividend distributed, which reduces the scheme's NAV.

## **5.3 Selecting Options within a Scheme**

Since there is no Additional Tax on Income Distributed (DDT) by an equity scheme, investors can opt for dividend option or growth option in equity schemes as per their liking.

In non-equity schemes, the dividend or growth option should be selected with care due to the implication of DDT and capital gains tax. Unit-holders who intend to hold their investment in non-equity schemes for more than three years may prefer the growth option. This will help them avoid paying the DDT of 28.84%. They will not incur tax of more than 20% with indexation benefit plus 3% cess on the long term capital gain.

Other non-corporate unit-holders who are not sure about holding their investment in non-equity schemes for more than three years may prefer the growth option if they are in the lower tax brackets (indicatively, if their annual taxable income is likely to be less than Rs 500,000).

Those with higher taxable income who are unsure if they will hold their investment in non-equity schemes for more than three years may prefer the dividend option.

### Summary

- Mutual fund schemes do not pay a tax on their capital gains or losses.
- Mutual fund schemes do not pay tax on their net income i.e. income minus expenses.
- The scheme incurs a Securities Transaction Tax (STT) on its equity market related transactions.
- When a debt scheme distributes dividend to its unit-holders, it has to pay an Additional Tax of Income Distribution (DDT).
- The dividend that the unit-holder receives is exempt from tax for both equity and debt schemes.
- When an investor sells units of an equity fund in the stock exchange, he will have to incur STT of 0.001% on the value of the transaction.
- STT is applicable on re-purchase of units of an open-end equity fund at 0.001%.
- STT is not applicable to purchase of units of equity scheme in the stock exchange or from the fund. It is also not applicable on transactions in debt securities or debt mutual fund schemes.
- In an equity mutual fund, if the units were held for more than a year, it would be a long-term capital gain; else it is short-term capital gain.
- The unit-holder pays tax on capital gains (at 15% of the gain) from equity schemes, only if the units are held for upto 1 year.
- In other types of mutual fund, if the units were held for more than three years, it would be a long-term capital gain; else it is short-term capital gain.
- In the case of non-equity schemes, if the unit-holder holds the units for less than three years, the capital gain is added to the taxable income of the unit-holder. In that case, tax rates will depend on the income tax slab of the unit-holder (which depends on his overall taxable income).
- The capital gains tax, if applicable, is not deducted by the scheme when paying the re-purchase proceeds to investors who are resident in India. Similarly, it is not deducted by the broker when the resident investor sells units of closed-end scheme in the stock exchange. The investor has to pay the capital gains tax to the income tax authorities on self-assessment basis.
- In the case of investors who are not resident in India, the scheme may pay the net re-purchase proceeds after making a deduction for Withholding tax.
- Since there is no Additional Tax on Income Distributed (DDT) by an equity scheme, investors can opt for either dividend or growth option in equity schemes.

- Unit-holders who intend to hold their investment in non-equity schemes for more than three years may prefer the growth option.
- Other non-corporate unit-holders who are not sure about holding their investment in non-equity schemes for more than three years may prefer the growth option if they are in the lower tax brackets.
- Those with higher taxable income who are unsure if they will hold their investment in non-equity schemes for more than three years may prefer the dividend option.

**Sample Questions**

- 1. Mutual fund schemes pay tax on capital gains at**
  - a. 10%
  - b. 15%
  - c. 30%
  - d. Tax is not applicable**
  
- 2. Investor pays a tax on the dividend that he receives from a mutual fund scheme at**
  - a. 10%
  - b. 15%
  - c. 30%
  - d. Tax is not applicable**
  
- 3. STT is applicable on**
  - a. Equity transactions**
  - b. Debt transactions
  - c. Gold transactions
  - d. All of the above
  
- 4. Withholding tax on capital gains may be applicable for**
  - a. All investors
  - b. Only investors who are resident in India
  - c. Only investors who are non-resident in India**
  - d. Short term gains only

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## CHAPTER 6: OFFER DOCUMENT

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- New Fund Offer and the process of issuing an NFO
- Offer Document and its two parts: Scheme Information Document and Scheme Information Document (SID)
- Key Information Memorandum

### 6.1 NFO Process

Units in a mutual fund scheme are offered to investors for the first time through a New Fund Offer (NFO). The following are a few key steps leading to the NFO:

- The AMC decides on a scheme to launch in 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 such investment objectives.
- 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 documents are filed with SEBI. The observations that SEBI makes on the Offer Document need to be incorporated. After approval by the trustees, the Offer Document can be issued 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.
- The AMC holds events for intermediaries, the press and electronic media to make them familiar with the scheme, its unique features, benefits it offers 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-end 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). The AMC announces Sale and Re-purchase prices from the Scheme Re-Opening Date.

Closed-end 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. However units of the closed-end schemes are mandatorily listed on the stock exchanges. Investors can buy or sell units from 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 NFO. Further, open-end schemes have to re-open for sale / re-purchase within 5 business days of the allotment.

<b>Operation</b>	<b>Period</b>
NFO Period	15 days ( except for ELSS & RGESS)
Allotment/Refund	Within 5 business days of NFO close
Scheme Re-opening date	Within the next 5 business days of Allotment/ Refund

## **6.2 Offer Document**

Investors get to know the details of an NFO through the Offer Document. Information like the nature of the scheme, its investment objectives and term, are the core of the scheme. Such vital aspects of the scheme are referred to as its *fundamental attributes*. These cannot be changed by the AMC without going through specific legal processes, including permission of investors.

In the event of change in fundamental attributes, investors who do not agree to the change have to be given an option to redeem their units without any exit load i.e. they will receive the entire NAV.

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 one of the most important sources of information on the scheme, to help prospective investors evaluate the merits and demerits of investing in it.

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 lived up to.

Investors need to note that their investment in mutual funds is governed by the principle of *caveat emptor* i.e. let the buyer beware. An investor is presumed to have read the Offer

Document, even if he has not actually read 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 scheme
- ***Statement of Additional Information (SAI)***, which has statutory information about the mutual fund that is offering the scheme.

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.

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

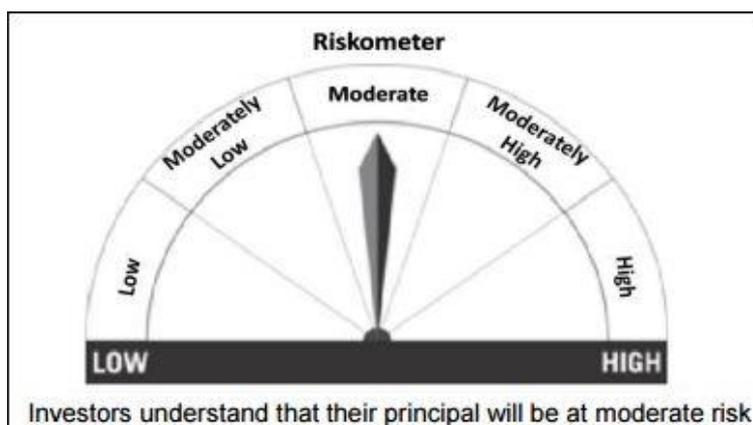
Both documents are prepared in the format prescribed by SEBI, and submitted to SEBI.

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.

### 6.3 Contents of SID

The cover page has information on the name of the scheme and its type. viz.

- Open-ended / Close-ended / Interval (the scheme structure)
- Equity / Balanced / Income / Debt / Liquid / ETF (the expected nature of scheme portfolio)
- Pictorial representation of risk in schemes via Riskometer. It represents five risk levels:
  - Low – principal at low risk
  - Moderately Low – principal at moderately low risk
  - Moderate – principal at moderate risk
  - Moderately High – principal at moderately high risk
  - High – principal at high risk



Besides, a single line description of the investment objective is included.

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.\\_\\_\\_\\_\\_](http://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”.

The SID has a Table of Contents, for easy access to specific information. The heads of information covered include:

- Highlights

This provides an overview of the scheme, including:

- Investment objective, policy and strategy

**Investment Objective** 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”

The **investment policy** gets into details of how the portfolio is proposed to be distributed between different types of assets (also called *asset allocation*). For example:

Equities 90-100%

Debt 0-10%

**Investment strategy** is decided regularly by the top management of the AMC based on developments in the economy and market. The SID mentions how this is decided.

- Liquidity

For example, the scheme may permit sale/ repurchase directly with the scheme or the units may be listed in specified exchanges.

- Benchmark
- Transparency/ NAV Disclosure
- Frequency with which the information will be made available
- Loads
- Minimum Application Amount

- Risk Factors

- Standard Risk Factors (that are common to all schemes)
- Scheme Specific Risk Factors

This helps the investor get an idea on the risks that the investor in that scheme is exposed to.

- Fees & Expenses

This is an important section that informs investors about the costs associated with the scheme. The investor’s returns in the scheme are pulled down by the costs.

- Rights of Unit-holders

An investor in a mutual fund scheme has various rights which are listed in this section.

- Penalties, Litigation etc.

This gives an idea on the manner in which the mutual fund runs its operations, and the regulatory or legal issues confronting it.

Draft SID is a public document, available for viewing in SEBI's website ([www.sebi.gov.in](http://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](http://www.amfiindia.com)) two days before the issue opens.

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

The SID of open-end scheme is updated at least once a year. Subsequent changes are printed on a separate piece of paper (addendum) and distributed along with the SID, until the SID is updated.

### 6.4 Contents of SAI

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

- 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](http://www.amfiindia.com)) investors can access the SAI of all the mutual funds.

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.

### 6.5 Key Information Memorandum

KIM is essentially a summary of the SID and SAI. It is more easily and widely distributed in the market. As per SEBI regulations, every application form is to be accompanied by the KIM. Some of the points covered in KIM 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

*Load* is a cost incurred by investors when they transact with the scheme.

The concept of Load is different from *Expenses*, which are incurred by the scheme as part of its operations. For example, on printing costs, investor servicing costs, commission to distributors etc.

- Contact information of Registrar for taking up investor grievances

KIM of open end schemes is to be updated at least once a year.

Candidates are advised to study the SID, SAI and KIM for any mutual fund scheme, to get a better understanding of the disclosures.

### Summary

- 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 observations that SEBI makes on the Offer Document need to be incorporated. After approval by the trustees, the Offer Document can be issued in the market.
- 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).
- The AMC announces Sale and Re-purchase prices for open-end schemes from the Scheme Re-Opening Date.
- Close-ended Schemes have NFO Open Date and NFO Close Date, but no Scheme Re-opening Date.
- Under the SEBI guidelines, NFOs other than ELSS and RGESS can remain open for a maximum of 15 days.
- Allotment / refund as the case may be, should be done within 5 business days of closure of the scheme.
- Open-ended schemes have to re-open for sale / re-purchase within 5 business days of the allotment.
- Information like the nature of the scheme, its investment objectives and term, are the core of the scheme. Such vital aspects of the scheme are referred to as its *fundamental attributes*.
- Investment in mutual funds is governed by the principle of *caveat emptor* i.e. let the buyer beware.
- Mutual Fund Offer Documents have two parts:
  - *Scheme Information Document (SID)*, which has details of the scheme
  - *Statement of Additional Information (SAI)*, which has statutory information about the mutual fund that is offering the scheme.
- In practice, SID and SAI are two separate documents, though the legal technicality is that SAI is part of the SID.

- The Offer Documents in the market are “vetted” by SEBI, though SEBI does not formally “approve” them.
- *Investment Objective* defines the broad investment charter.
- The *investment policy* gets into details of how the portfolio is proposed to be distributed between different types of assets (also called *asset allocation*).
- *Investment strategy* is decided regularly by the top management of the AMC based on developments in the economy and market.
- A single SAI is relevant for all the schemes offered by a mutual fund.
- *Key Information Memorandum (KIM)* is essentially a summary of the SID and SAI. It is more easily and widely distributed in the market.
- As per SEBI regulations, every application form is to be accompanied by the KIM.
- SID of open-end schemes and SAI of mutual funds are required to be updated every year.

**Sample Questions**

- 1. Offer document of mutual fund scheme is prepared by**
  - a. **AMC**
  - b. Trustees
  - c. RTA
  - d. SEBI
  
- 2. SEBI \_\_\_\_\_ offer documents of mutual fund schemes.**
  - a. **Vets**
  - b. Approves
  - c. Approves or disapproves
  - d. Registers
  
- 3. Close-end schemes do not have**
  - a. NFO open date
  - b. NFO close date
  - c. **Scheme re-open date**
  - d. All of the above
  
- 4. Application form needs to be attached to**
  - a. SID
  - b. SAI
  - c. **KIM**
  - d. All of the above

## CHAPTER 7: FUND DISTRIBUTION & SALES PRACTICES

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Various types of entities/distribution channels of mutual funds schemes
- Pre-requisites for selling mutual fund schemes
- Transaction charges related to mutual funds schemes
- Commission structure for distributors of mutual fund schemes
- Code of conduct and guidelines prescribed by AMFI for selling of mutual fund schemes
- SEBI regulations related to sales practice

### 7.1 Distribution Channels

The following types of entities are involved in distributing mutual funds in India:

- *AMCs*  
AMCs have a dedicated sales force that actively distributes mutual fund schemes to large investors. Unlike the other entities that may sell schemes of more than one mutual fund, AMCs distribute only their own mutual fund schemes.
- *Independent Financial Advisers (IFAs)*  
These are individuals providing investment advice. Some of the larger IFAs have support staff to cater to investor needs.
- *Bank distributors*  
Investment advisers, relationship managers and wealth managers in banks assist the bank's customers with their investments, including mutual funds.
- *Non-bank distributors* include securities distribution companies and non-banking finance companies. Many of them have offices all over the country.
- *Members (brokers) of the stock exchange*  
They offer two kinds of mutual fund services:
  - Purchase and sale of units of closed-end schemes and ETFs in the stock exchange. This is done through the normal screen-based trading software that is used for transactions in shares.
  - Mutual fund transactions of investors in other situations, such as investment in NFOs (both open-end and closed-end), sale / re-purchase of units of open-end

schemes etc. In order to facilitate such transactions by its members, both BSE and NSE have developed mutual fund transaction engines.

AMFI-registered mutual fund distributors who make the requisite arrangements with the stock exchange/s can also use the stock exchange infrastructure to help their clients purchase and redeem mutual fund units.

- Post-offices, Self-help Groups etc., have emerged as *alternate channels* of mutual fund distribution.
- *Internet Channel*

AMCs, large distribution houses and some mutual fund information companies actively use the internet as a channel to reach out to investors and handle their mutual fund transactions.

### 7.2 Pre-requisites to Sell Mutual Fund Schemes

SEBI has prescribed a Certifying Examination, passing in which is compulsory for anyone who is into selling of 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 fund schemes, 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.

Since June 1, 2010 NISM-Series-V-A: Mutual Fund Distributors (MFD) Certification Examination is the mandatory examination 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

NISM-Series-V-B: Mutual Fund Foundation (MFF) Certification Examination is the mandatory examination for the new cadre of distributors who wish to sell only simple and performing mutual fund schemes.

- *Know Your Distributor (KYD) Requirements*

As part of SEBI's drive to streamline the distribution process of mutual fund products, AMFI has introduced KYD. It consists of document verification and bio-metric process.

- Self-attested copy of the PAN card and specified documents as proof of address have to be submitted along with an application form at the office of CAMS- Point of Service (CAMS-PoS).
- Bio-metric process consists of taking the impression of the index finger of the right hand. This is done at the office of CAMS-PoS at the time submission of documents.  
In case of non-individual distributors, bio-metric process is conducted on specified authorized persons.

An acknowledgement confirming the completion of KYD process is received from the CAMS-PoS.

- 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 KYD process is also applicable for existing distributors seeking to renew their ARN.

### 7.3 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.

### 7.4 Transaction Charge

SEBI permits transaction charge as follows:

- Rs 150 per investment of Rs10,000 and above from a first time investor in mutual funds
- Rs 100 per investment of Rs10,000 and above from existing investors in mutual funds

In the case of SIPs, transaction charge of Rs 100 is payable in 4 instalments, provided that the total investment commitment is Rs 10,000 or above.

Distributors are not supposed to split the investment amount of the investor or make a wrong declaration of first time investor, to benefit from the transaction charge.

The transaction charge is deducted from the investor's investment, and paid to the distributor. The balance is invested on behalf of the investor.

The transaction charge is only on purchases / subscriptions. It is not applicable on any other transactions.

The distributor can decide the types of mutual fund schemes where he wants to recover transaction charge, and those where he does not want to recover the charge. The distributor's choice in this respect will be applicable to all the selected scheme types, from any mutual fund. He cannot decide to charge from some investors, and not charge from others.

The default option is that the distributor has opted out of levying the transaction charge. The selection regarding 'opting in' or 'opting out' of the transaction charge is to be exercised through a letter in the prescribed form to be sent to CAMS-POS in two half-yearly windows i.e. between March 1st to March 25th and September 1st to September 25th. The new status change will be applicable from the immediately succeeding month.

### 7.5 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 AMC can charge each type of scheme towards total expense (including commission).

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

- *Initial or Upfront Commission*

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.

AMCs may also pay upfront commission to distributors. AMFI, as part of the best practice guidelines, has capped upfront commission at 1% of the investment amount from 1 April 2015. Further, the upfront commission shall not exceed Total Expense Ratio of the scheme, if the same is below 1%.

- *Trail commission*

This is 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 or monthly 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. Later, suppose the NAV of the scheme goes up to Rs 15. Trail commission is payable on 1000 units X Rs 15 i.e. Rs 15,000 – not the Rs10,000 mobilised.

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

Such indexing of agent commissions to the share market, 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.

### **7.6 Nature of Relationship**

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.

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

### **7.7 SEBI Regulations Relating 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 to the client 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.

## **7.8 ACE and AGNI**

Every person who is into selling of mutual funds should be familiar with the AMFI Code of Ethics (ACE) and AMFI's Guidelines & Norms for Intermediaries (AGNI).

### **7.8.1 ACE**

ACE sets out standards of good practices to be followed by AMCs in their operations and in their dealings with investors, intermediaries and the public. It sets out standards with respect to integrity, due diligence, disclosures, professional selling practices, investment practices, operations and reporting practices.

### **7.8.2 AGNI**

AGNI is a set of guidelines and code of conduct for intermediaries, consisting of individual agents, brokers, distribution houses and banks engaged in selling of mutual fund products. AMFI's revised code of conduct mandates the following responsibilities on intermediaries-

- Consider investor's interest as paramount and take necessary steps to ensure that the investor's interest is protected in all circumstances.
- 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.
- 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.
- 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.
- 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.
- Abstain from indicating or assuring returns in any type of scheme, unless the SID is explicit in this regard.

- 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.
- 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.
- Do not undertake commission driven malpractices such as:
  - Recommending inappropriate products solely because the intermediary is getting higher commissions there from.
  - Encouraging over transacting and churning of Mutual Fund investments to earn higher commissions.
  - Splitting of applications to earn higher transaction charges / commissions.
- 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.
- 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.
- Maintain confidentiality of all investor details, deals and transactions.
- 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.
- Intermediaries shall not rebate commission back to investors and abstain from attracting investors through temptation of rebate/gifts etc.
- 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.

- Intermediaries including the sales personnel of intermediaries engaged in sales / marketing shall obtain NISM certification and register themselves with AMFI and obtain a 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.
- Intermediaries shall comply with the Know Your Distributor (KYD) norms issued by AMFI.
- 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.
- 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.
- 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.
- Adhere to AMFI guidelines and Code of Conduct issued from time to time related to distributors, selling, distribution and advertising practices.
- 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.
- 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.
- 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.
- 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.

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

SEBI 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:

- AMFI will 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.

### Summary

- AMCs distribute only their own mutual fund schemes.
- IFAs are individuals providing investment advice.
- Stock exchange members (brokers) offer two kinds of mutual fund services:
  - Purchase and sale of units of closed-end schemes and ETFs in the stock exchange. This is done through the normal screen-based trading software that is used for transactions in shares.
  - Mutual fund transactions of investors in other situations, such as investment in NFOs (both open-end and closed-end), sale / re-purchase of units of open-end schemes etc. In order to facilitate such transactions by its members, both BSE and NSE have developed mutual fund transaction engines.
- AMFI-registered mutual fund distributors who make the requisite arrangements with the stock exchange/s can also use the stock exchange infrastructure to help their clients purchase and redeem mutual fund units.
- Post-offices, Self-help Groups etc. have emerged as alternate channels of mutual fund distribution.
- As part of SEBI's drive to streamline the distribution process of mutual fund products, AMFI has introduced Know Your Distributor (KYD) process. It consists of document verification and bio-metric process.
- On registration, AMFI allots an AMFI Registration Number (ARN).
- 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 an AMC is a simple process. There is a standard Request for Empanelment Form to be filled.
- SEBI permits transaction charge as follows:
  - Rs 150 per investment of Rs 10,000 and above from a first time investor in mutual funds
  - Rs 100 per investment of Rs 10,000 and above from existing investors in mutual funds
- In the case of SIPs, transaction charge of Rs 100 is payable in 4 instalments, provided that the total investment commitment is Rs 10,000 or above.
- The transaction charge is deducted from the investor's investment, and paid to the distributor. The balance is invested on behalf of the investor.

- The transaction charge is only on purchases / subscriptions. It is not applicable on any other transactions.
- The distributor can decide the types of mutual fund schemes where he wants to recover transaction charge. The distributor's choice in this respect will be applicable to his mobilisation through all the selected scheme types, from any mutual fund.
- Distributor cannot decide to charge from some investors, and not charge from others.
- 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.
- Two kinds of commission are earned by distributors on their mobilization: *Initial (or upfront) Commission* and *Trail Commission*.
- 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.
- Trail commission is calculated as a percentage of the net assets attributable to the Units sold by the distributor. Distributors benefit from increase in net assets arising out of valuation gains in the market.
- Unlike products like insurance, where agent commission is paid for a limited number of years, a mutual fund distributor is paid a trail commission for as long as the investor's money is held in the fund.
- 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.
- Typically, AMCs structure their relationship with distributors as Principal to Principal. Therefore, the AMC is not bound by the acts of the distributor, or the distributor's agents or sub-brokers.
- Distributors can claim commission on investments made through them by their clients. However, no commission is payable on their own investments.
- The practice of *rebating* i.e., sharing part of the commission earned with the investors, is banned.
- AMFI Code of Ethics (ACE) sets out standards of good practices to be followed by AMCs in their operations and in dealings with investors, intermediaries and the public.
- AMFI's Guidelines & Norms for Intermediaries (AGNI) is a set of guidelines and code of conduct for intermediaries, consisting of individual agents, brokers, distribution houses and banks engaged in selling of mutual fund products.

**Sample Questions**

1. \_\_\_\_\_ are individuals offering investment advice.
  - a. IFAs
  - b. Brokerages
  - c. Distributors
  - d. NBFCs
  
2. Which of the following is the last step before distributors can start selling mutual funds.
  - a. NISM certification
  - b. ARN
  - c. KYD
  - d. Empanelment
  
3. The maximum transaction charge is \_\_\_\_\_ per application
  - a. Rs 100
  - b. Rs 150
  - c. Rs 200
  - d. Rs 100 in 4 instalments
  
4. Trail commission is paid
  - a. For 1 year
  - b. For 3 years
  - c. For 5 years
  - d. So long as investor's moneys are with the scheme

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## CHAPTER 8: INVESTOR TRANSACTIONS

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Investors eligible to purchase different types of mutual funds schemes
- KYC requirement for mutual fund investors—individual and institutional
- Concept of Micro SIPs, demat account, cut-off timing and time stamping
- KYC process followed for distributors by the KRAs
- Different kinds of investor's transaction in mutual funds—fresh purchases and additional purchases through different payment mechanisms
- Cut-off timing for redemption and subscription of mutual fund schemes
- Mutual fund transactions through stock exchanges

### 8.1 Who can Invest in Mutual Funds

The following are eligible to purchase Units of most mutual fund schemes:

#### 8.1.1 Individual Investors

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 parents/ lawful 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*

An Indian citizen, who is working abroad, and his / her 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. 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 Unit.

- *Qualified Foreign Investors (QFIs)*

These are foreigners from certain countries that are permitted to invest in mutual fund schemes (and equity shares). SEBI has detailed the requirements and routes through which such investors, who are not Indians, can invest.

QFI may also be a non-individual, like a company.

### 8.1.2 Non-individual Investors

Non-individual investors include:

- Companies / corporate bodies, registered in India
- Registered societies and co-operative societies
- 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

Here, the individuals who sign the documents are called authorised signatories and are investing on behalf of organizations / institutions they represent.

Some schemes are meant only for specific types of investors. It is a good practice to check the 'Who can Invest' section of the Offer Document.

### 8.2 KYC Requirements for Mutual Fund Investors

Broadly, mutual fund investors need the following documents:

- Proof of Identity
- Proof of Address
- PAN Card (exempted for Micro-SIP, discussed in next section, and investments upto Rs 50,000 per investor per mutual fund per financial year)
- Photograph

Capital market intermediaries, such as select branches / offices of mutual funds, registrars, large distributors, stock exchange brokers and depository participants serve as Points of Service (PoS) for the KYC documentation. Investors will need to provide the Originals, along with a copy of the relevant documents, to any of the PoS (listed in AMFI website – [www.amfiindia.com](http://www.amfiindia.com)). The Originals will be returned after verification. Alternatively, the investor can provide a True Copy attested by a Notary Public, Gazetted Officer or Manager of a Scheduled Commercial Bank.

SEBI has instituted a centralised KYC process for the capital market, including mutual funds. This is a significant benefit for the investor. Based on completion of KYC process with one capital market intermediary, the investor can invest across the capital market. KRAs facilitate this centralised KYC process. So far, SEBI has approved 5 KRAs:

- CDSL Ventures Ltd ([www.cvlkra.com](http://www.cvlkra.com))
- NSDL Database Management Ltd ([www.ndml.in](http://www.ndml.in))
- DotEx International Ltd ([www.nsekra.com](http://www.nsekra.com))
- CAMS Investor Services Pvt. Ltd ([www.camskra.com](http://www.camskra.com))
- Karvy Data Management Services Limited ([www.karvykra.com](http://www.karvykra.com))

Once a capital market intermediary has performed an In Person Verification of the investor and other documentation requirements are in place, and the intermediary uploads the investor's data to the database of a KRA, the KYC is valid across the capital market. The investor can benefit from that KYC to invest in any part of the capital market (not limited to mutual funds).

Similarly, in the event of change of address or any other information, the investor needs to fill the standard form and follow the prescribed process only once, with any of the PoS. Based on that, the information will be updated with all the capital market entities where the investor has invested.

Where investment is made by a minor, KYC requirements have to be complied with by the parent or lawful guardian.

At times, investments are made by a Power of Attorney (PoA) holder. For example, father invests on behalf of son who is major and who gives a PoA. KYC requirements have to be complied with, by both, investor and PoA holder.

### 8.3 Micro SIPs

These are SIPs by individuals, minors and sole-proprietary firms, where annual investment (12 month rolling or April-March financial year) does not exceed Rs 50,000. PAN Card is not required in such cases. However, the investor (including joint holders) will have to submit one of the following Photo-Identity documents:

- Voter Identity Card
- Driving License
- Aadhar Card issued by Unique Identification Authority of India
- Government / Defence identification card
- Passport
- Photo Ration Card
- Photo Debit Card (Credit card not included).
- 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 created 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 Scheme (NPS) subscribers by Central Registration Agency (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.

Further, 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. It is available for NRIs, but not PIOs.

### 8.4 Additional Documents 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, 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.

These documentation requirements for institutional investors are in addition to the normal KYC documentation, discussed earlier.

### 8.5 Distributor Processes for KYC

There are some differences in the processes adopted by the KRAs. The distributor can check the specifics in the website of the relevant KRA. The following are the generalised processes adopted by KRAs:

#### 8.5.1 Registration with the KRA

The KRA has a standard form and documents that the distributor needs to submit in physical form. Based on electronic submission of the relevant information, the KRA provides the distributor, access to its system for a limited period of about 14 days.

#### 8.5.2 Confirmation of KYC Compliance of Client

Some investors will be KYC compliant (through some other capital market intermediary). This can be confirmed by seeking a copy of the KYC Acknowledgement Letter issued by a KRA to the client. It can also be verified through the website of any KRA, using the client's PAN and date of birth.

### 8.5.3 Registration of KYC of Client

This is required if the client is not already KYC compliant.

- Get the client to fill the standard KYC form.
- The KYC form has to be accompanied by the Proof of Identity and Proof of Address documents. Non-individuals need to submit more documents, as already discussed.
- The intermediary needs to verify the documents with the KYC form.
- The client needs to be physically present, for the intermediary to confirm his / her In Person Verification.
- Based on the above, the intermediary has to enter the details in the KRA system.
- The documents need to be sent to the KRA in whose system the client details were entered.
- Similarly, any changes in demographic information of the client can be entered in the KRA system and the relevant documents sent to the KRA.

### 8.6 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.

The benefits of demat facility for mutual fund investors have increased, with National Stock Exchange and Bombay Stock Exchange making available screen-based platforms for purchase and sale of mutual fund schemes.

Investors can go to a Depository Participant (DP, which is generally a bank or a broking house) and demat their investment holding i.e. convert their physical units into demat units. In order to avail of this facility, the DP will insist on the investor opening a demat account. As already mentioned, KYC performed by the DP is valid for the investor to invest in mutual funds.

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:

- Demat account is compulsory for investors to transact in ETF units

- Paperwork in buying or selling the units, and correspondingly, accepting or giving delivery of the units is minimised.
- Bonus and rights units that the investor is entitled to, are directly credited into the investor's demat account.
- For all demat units (or shares), change of address or other details need to be given only to the DP, instead of separately to every mutual fund (or company) where the investor has invested.

The investor also has the option to convert the demat units into physical form. This process is called 're-materialisation'.

### **8.7 Investor's Transactions with the Fund**

#### **8.7.1 Fresh Purchases**

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. in situations where the investor does not have an investment account (known as "folio") with the specific mutual fund. The mutual fund would need the application form with the prescribed documentation and the requisite investment amount, to allot an investment folio in the name of the investor.

While investing, the investor needs to confirm that the investment is above the minimum investment limit set by the mutual fund for the scheme.

#### **8.7.2 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 transaction slip needs to be filled, and submitted with the requisite payment. The transaction slip can be similarly used in the event of change in any information e.g. address of investor.

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.

#### **8.7.3 Online Transactions**

This facility is given to an existing investor in a mutual fund. The investor is required to fill the requisite details in an application form. Based on this, the registrar would allot a user name and password (Personal Identification Number – PIN). This can be used by the investor to

make further 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.

### 8.7.4 Payment Mechanism for Purchases

- *Cash*

Investment in cash is limited to Rs 50,000 per investor per mutual fund per financial year. The mutual fund is expected to follow the applicable anti-money laundering regulations.

Although investment can be made in cash in such exceptional situations, redemptions as well as dividend payments by the scheme to the investors need to be made only through banking channels.

- *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 outside the location where the application form / transaction slip is being submitted.

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. Third-party cheques are not accepted except in special cases such as grand-parents/parents making payments not exceeding Rs50,000 on behalf of a minor, employer making payments on behalf of employee through payroll deductions and custodian investing on behalf of FIIs.

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*

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.

Before money is remitted directly to the mutual fund, it is advisable to get the proper bank account details from the AMC / distributor. Further, the application form / transaction slip will need to be accompanied by proof of the remittance.

- *Electronic Clearing Service (ECS) / Standing Instructions*

These 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 banks, 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*

Mobile banking is nascent in India. Once people are comfortable with M-banking, this will become a convenient way to invest.

### **8.7.5 Allotment of Units to Investor**

- In an NFO, Units are sold at the face value i.e. Rs 10. So the investment amount divided by Rs 10 would give the number of units the investor has bought.

If investor invests Rs 5,000, he will receive  $\text{Rs } 5,000 \div \text{Rs } 10$  i.e. 500 units.

- As part of ongoing sales in an open-end scheme, units are sold at the sale price, which in turn is the applicable NAV.

If investor invests Rs 5,000, and the applicable Sale Price is Rs20 he will receive  $\text{Rs } 5,000 \div \text{Rs } 20$  i.e. 250 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.

If investor invests Rs 5,000 and the Rights Price is Rs 25, he will receive  $\text{Rs } 5,000 \div \text{Rs } 25$  i.e. 200 units.

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 1:2 bonus issue, the investor is allotted 1 new unit (free) for every 2 units already held by the investor. An investor who had 1 unit will have 1.5 units after the bonus issue.

Since the net assets of the scheme remain the same, only the number of units increases and the NAV will get reduced proportionately.

If NAV was Rs 30, then after a 1:2 bonus issue, NAV will become  $\text{Rs } 30 \div 1.5$  i.e. Rs 20.

### **8.7.6 Re-purchase of Units**

The investor in an open end scheme can offer the units for repurchase to the mutual fund (in the market the transaction is commonly referred to as “redemption”). 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 (i.e. redemption price) is the applicable NAV less exit load.

For example, if applicable NAV is Rs 15 and exit load is 1%, re-purchase price will be Rs 15 less 1% i.e. Rs 14.85.

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. In the above case, if investor specified Rs 14,850 as the re-purchase amount, his unit-holding will go down by  $\text{Rs } 14,850 \div \text{Rs } 14.85$  i.e. 1,000 units.

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.

In the previous case, if investor indicated a re-purchase of 100 units, then the re-purchase amount would be 100 units X Rs. 14.85 per unit i.e. Rs 1,485.

If, while effecting the re-purchase, the investment holding in the folio goes below the minimum limit set by the mutual fund for the scheme, then all the units will be re-purchased and the investment folio of the investor would be closed.

### 8.8 Payment Mechanism for Re-purchase 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 avoided.

The investor can register upto 5 bank accounts. One of them has to be selected as default bank account. AMCs will directly transfer the re-purchase proceeds (and dividends) to the default bank account.

Registration of bank account entails submitting an application to ISC using 'Multiple Bank Account Registration' Form. One cancelled cheque leaf of the concerned bank account has to be submitted for every bank account sought to be registered.

'New Bank Mandate Details with Attestation from Bank Branch Manager' Form is available for confirmation of the bank details and signature.

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.

## 8.9 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 uniform cut-off timing to determine the applicable NAV.

The provisions, which are uniformly applicable for all mutual funds, are as follows:

Transaction	Applicable NAV
<b>Liquid Schemes:</b>	
Subscription application received and funds available for utilisation before 2 pm	Closing NAV of the day immediately preceding the day of receipt of application
Subscription application received after 2 pm but funds available for utilisation on same day	Closing NAV of the day immediately preceding the next business day
Funds not available for utilisation before cut off time irrespective of time of receipt of application	Closing NAV of the day immediately preceding the day on which funds are available for utilization
Redemption requests received up to 3 pm	Closing NAV of the day immediately preceding the next business day
Redemption requests received after 3 pm	Closing NAV of next business day
<b>Other Schemes (including Equity schemes)</b>	
Subscription application upto Rs 2 lakh received before 3 pm	Closing NAV of application date
Subscription application upto Rs 2 lakh received after 3 pm	Closing NAV of next business day
Subscription application above Rs 2 lakh	Closing NAV of the day on which the funds are available for utilization
Redemption requests received up to 3 pm	Closing NAV of the same day
Redemption requests received after 3 pm	Closing NAV of next business day

### 8.10 Time-Stamping

Mutual funds disclose official Points of Acceptance (PoAs) and their addresses in the SID and their website. All transaction requests need to be submitted at the PoAs. The PoAs have time stamping machines with tamper-proof seal to ensure fairness to investors.

The distributor may accept the transaction request from the investor, but this would need to be sent to a PoA at the earliest. When the cut-off timing is applied, the time when it is submitted to the PoA is relevant and not the time when the investor submits the transaction request to the distributor.

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.

### 8.11 Transactions through Stock Exchange

Closed-end scheme units can be bought and sold like any share through the normal screen-based trading system of the exchange. The system can be accessed through a broker's terminal or through the internet.

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 open-end schemes, 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 ISC of the RTA.

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.

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 is available to address any investor complaints.

### Summary

- Individuals and non-individuals are permitted to invest in mutual funds. The documentation requirements vary with type of investor.
- Upto 3 people are permitted to invest as joint investors.
- In the case of HUF, the head of the family (called 'karta') invests on behalf of the family.
- 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.
- Foreigners are permitted to invest as Qualified Foreign Investors (QFIs). They may be individuals or non-individuals.
- Minors can invest through their parents / legal guardians.
- Broadly, investors need Proof of Identity, Proof of Address, PAN Card and Photograph as part of Know Your Customer (KYC) to invest.
- PAN card is exempt in the case of small investments (upto Rs 50,000 per year per mutual fund) and micro-SIPs (upto Rs 50,000 investment per year across all mutual funds).
- Micro SIPs are permitted for individuals, minors and sole-proprietary firms. Relaxation in documentation requirements for micro-SIPs is not available for HUFs and non-individuals. It is available for NRIs, but not PIOs.
- Capital market intermediaries, such as select branches / offices of mutual funds, registrars, large distributors, stock exchange brokers and depository participants serve as Points of Service (PoS) for the KYC documentation.
- SEBI has instituted a centralised KYC process for the capital market, including mutual funds. This is a significant benefit for the investor. Based on completion of KYC process with one capital market intermediary, the investor can invest across the capital market. KYC Registration Agencies (KRA) facilitate this.
- In the event of change of address or any other information, the investor needs to fill the standard form and follow the prescribed process only once, with any of the PoS.
- So far, SEBI has approved 5 KRAs: CDSL Ventures Ltd ([www.cvlkra.com](http://www.cvlkra.com)), NSDL Database Management Ltd ([www.ndml.in](http://www.ndml.in)). DotEx International Ltd ([www.nsekra.com](http://www.nsekra.com)), CAMS Investor Services Pvt. Ltd ([www.camskra.com](http://www.camskra.com)) and Karvy Data Management Services Limited ([www.karvykra.com](http://www.karvykra.com)).
- Where investment is made by a minor, KYC requirements have to be complied with by the Guardian.

- At times, investments are made by a Power of Attorney (PoA) holder. For example, father invests on behalf of son who is major and who gives a PoA. KYC requirements have to be complied with, by both, investor and PoA holder.
- Investors can go to a Depository Participant (DP, which is generally a bank or a broking house) and demat their investment holding i.e. convert their physical units into demat units.
- Demat account is compulsory for investors to transact in ETF units.
- The investor also has the option to convert the demat units into physical form. This process is called 're-materialisation'.
- 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 transaction slip needs to be filled, and submitted with the requisite payment.
- Investment in cash is limited to Rs 50,000 per investor per mutual fund per financial year. Although investment can be made in cash in such exceptional situations, redemptions as well as dividend payments by the scheme to the investors needs to be made only through banking channels.
- Cheques accompanying the investment application are to be signed by the investor. Third-party cheques are not accepted except in special cases such as grand-parents/parents making payments not exceeding Rs 50,000 on behalf of a minor, employer making payments on behalf of employee through payroll deductions and custodian investing on behalf of FIIs.
- 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).
- 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 banks, then ECS is used.
- Application Supported by Blocked Amount (ASBA) 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 investor can register upto 5 bank accounts. One of them has to be selected as default bank account. AMCs will directly transfer the re-purchase proceeds (and dividends) to the default bank account.
- 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.

- Mutual funds disclose official Points of Acceptance (PoAs) and their addresses in the SID and their website. All transaction requests need to be submitted at the PoAs. The PoAs have time stamping machines with tamper-proof seal to ensure fairness to investors.
- Closed-end scheme units can be bought and sold like any share through the normal screen-based trading system of the exchange. The system can be accessed through a broker's terminal or through the internet.
- 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.

**Sample Questions**

- 1. Which of the following is permitted to invest in mutual funds in India?**
  - a. Individuals
  - b. HUF
  - c. Qualified Foreign Investors
  - d. All of the above**
  
- 2. The limit for micro SIPs is \_\_\_\_\_ p.a.**
  - a. Rs 20,000 per mutual fund
  - b. Rs 20,000 for all mutual funds together
  - c. Rs 50,000 per mutual fund
  - d. Rs 50,000 for all mutual funds together**
  
- 3. Where investment is by minor, KYC compliance is required from**
  - a. The minor
  - b. The guardian**
  - c. The minor and guardian
  - d. No KYC required
  
- 4. Mutual fund investor can register upto \_\_\_\_\_ bank account/s**
  - a. 1
  - b. 2
  - c. 4
  - d. 5**

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## CHAPTER 9: INVESTMENT SERVICES

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Different types of plans—Systematic Investment Plan, Systematic Withdrawal Plan, Systematic Transfer Plan, Trigger Option
- Mutual funds statement of account and consolidated account statement
- Nomination and Pledging

### 9.1 Options within a Scheme

As discussed in Chapter 1, most schemes offer a dividend option and growth option. The dividend option can have two sub-options:- dividend payout and dividend re-investment.

The options are offered with a single scheme portfolio. Therefore, portfolio performance is the same for all options. The difference is in the treatment of dividend and related taxation, and therefore their NAV, as discussed in earlier Units. The implications are summarised in the following table:

Parameter	Dividend Payout Option	Dividend Re-investment Option	Growth Option
<i>Dividend received in bank account of investor</i>	Yes	No	No
<i>Income Distribution Tax</i>	Yes, for debt schemes	Yes, for debt schemes	No
<i>Increase in number of units on account of re-investment of dividend</i>	No	Yes	No
<i>NAV change</i>	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

## **9.2 Systematic Plans**

### **9.2.1 Systematic Investment Plan (SIP)**

It is considered to be a good practice to invest regularly. 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.

Suppose an investor were to invest Rs 1,000 per month for 6 months. If, in the first month, the NAV is Rs 10, the investor will be allotted  $\text{Rs } 1,000 \div \text{Rs } 10$  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  $\text{Rs } 1,000 \div \text{Rs } 12$  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  $\text{Rs } 1,000 \div \text{Rs } 9$  i.e. 111.111 units.

Thus, the investor acquires his Units closer to the average of the NAV on the 6 transaction dates during the 6 month period. This is why this approach is also called *Rupee Cost Averaging*.

Through an SIP, the investor does not end up in the unfortunate position of acquiring all the units in a market peak.

Mutual funds make it convenient for investors to lock into SIPs by investing through Post-Dated Cheques (PDCs), ECS or standing instructions.

### **9.2.2 Systematic Withdrawal Plan (SWP)**

Just as investors do not want to buy all their units at a market peak, they do not want all their units redeemed in a market trough. Investors can therefore opt for the safer route of offering for re-purchase, a constant value of units.

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  $\text{Rs } 1,000 \div \text{Rs } 10$  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.  $\text{Rs } 1,000 \div \text{Rs } 12$  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.  $\text{Rs } 1,000 \div \text{Rs } 9$  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, to minimise the risk of redeeming all the units during a market trough.

- To meet liquidity needs for regular expenses.

As discussed under Taxation, debt schemes are subject to Dividend 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 dividend distribution tax).

- If the scheme is profitable, re-purchase ensures that some of the profits are being regularly encashed by the investor.

### **9.2.3 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 which 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.
- He 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 to do two sets of paper work (re-purchase and subscription) for every period.

The STP offered by mutual funds is a cost-effective and convenient facility.

## **9.3 Triggers**

It is not uncommon for investors to regret 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, his 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 actioned, the investor loses on the further gain.

Similarly, an investor can set a trigger to transfer moneys from a liquid scheme 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%.

Investors should study the conditions attached to trigger options (and any other value added service), because these vary from scheme to scheme.

Summary of different options in mutual funds

<b>Option</b>	<b>How it works?</b>
SIP	Investor invests a fixed amount at regular intervals. For example, Aamir invests Rs. 5,000 every month.
SWP	Investor withdraws a fixed amount at regular intervals. This amount is credited in his bank account. For example Aamir withdraws Rs. 5,000 every month.
STP	Investor transfers a fixed amount from one mutual fund scheme to another. For example, Aamir initiates a STP of Rs. 5,000 from a debt scheme to an equity scheme.
Trigger	Investor specifies a target return on the investment. Once the target is achieved, the money is transferred from equity scheme to debt scheme or vice versa. For example, Aamir gave an instruction stating, if equity scheme generates 20% returns then the returns need to be transferred to debt scheme.

#### **9.4 Statement of Account**

Mutual funds issue Statement of Accounts (SoA) for every folio, every month, if there is a transaction during the month. It shows for each transaction (sale / re-purchase) during the period, 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.

Even if there are no transactions in the folio, mutual funds issue SoA every 6 months.

#### **9.5 Consolidated Account Statement (CAS)**

This is a single account statement that consolidates financial transactions in all folios of an investor across all schemes of all mutual funds. The consolidation of investor's records across schemes and mutual funds is done on the basis of PAN.

All types of financial transactions like purchase including NFOs, redemption including maturity, switches, systematic transactions like SIP, SWP and STP, dividend payouts or reinvestments, merger, bonus transactions etc. are covered.

Non-financial transactions like updation of address, bank details, nominee registration etc. are not included. Confirmation for non-financial transactions is sent separately by individual AMCs.

Demat transactions are not covered in CAS. These are part of the demat statement sent by the DP.

Folios of minors too are not shown in the CAS.

Details such as, opening and closing unit balances in each folio, financial transactions, the email id registered, nominee registration status, mode of holding and KYC status are included in CAS. However, sensitive information like registered bank account details, PAN and contact numbers are not included. Mobile number shown in CAS is masked.

CAS is sent to the KYC address of the investor. However, if KYC is not updated in any of the folios considered for consolidation, then CAS is sent to the address available in such folio where the investor had transacted the last transaction in the month.

CAS is sent on or before the 10<sup>th</sup> of every calendar month, where there is a financial transaction in the folio in the previous month. In case there is no transaction during the half-year, CAS is sent in the month following March or September.

### 9.6 Unit Certificate and Demat

Unlike SoA and CAS, which shows the flow of unit-holding during the period, a Unit Certificate only confirms the number of units held in the name of 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.

In practice, open-end schemes issue SoA, while closed-end schemes issue Unit Certificates. Since physical units of open-end schemes are non-transferable, Unit Certificate does not offer any real transactional convenience for the Unit-holder. However, if a Unit-holder asks for it, the AMC is bound to issue a Unit Certificate.

As already discussed, the investor can hold his units in demat form. In that case, Unit Certificate is not issued to the investor. Instead, he receives a confirmation from the DP on the change in demat units in his account. Demat units are freely transferable.

### 9.7 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.

If the nominee is a minor, then a guardian too can be specified.

In the case of joint holding, every unit-holder will have to sign the nomination form. 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 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 are to be submitted to the AMC.

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 inheritance laws applicable to the unit-holder too need to be considered by the investor. Professional advice on inheritance issues and preparation of a Will are strongly advised.

### 9.8 Pledge

Banks, Non-Banking Financial Companies (NBFC) and other financiers often lend money against pledge of units by the Unit-holder. 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.

### 9.9 Other Services

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.

The range of investment options, plans and services offered in the industry make it attractive for every investor to invest in mutual fund schemes.

### Summary

- Dividend and growth options are offered with a single scheme portfolio. Therefore, portfolio performance is the same for all options. The difference is in the treatment of dividend and related taxation.
- *Systematic Investment Plan (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. This approach is also called *Rupee Cost Averaging*.
- Mutual funds make it convenient for investors to manage their *Systematic Withdrawal Plans (SWPs)* by indicating the amount, periodicity (generally, monthly) and period for their SWP.
- Debt schemes are subject to Dividend 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 Dividend Distribution Tax) as compared to dividend (which would be liable to Dividend Distribution Tax).
- *Systematic Transfer Plan (STP)* 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 which is withdrawn from a scheme is re-invested in some other scheme of the same mutual fund.
- Trigger option 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, his units would be re-purchased, without the need for going through a separate re-purchase documentation.
- Mutual funds issue Statement of Accounts (SoA) for every folio, every month, if there is a transaction during the month. Even if there are no transactions in the folio, mutual funds issue SoA every 6 months.
- Consolidated Account Statement (CAS) is a single account statement that consolidates financial transactions in all folios of an investor across all schemes of all mutual funds. The consolidation of investor's records across schemes and mutual funds is done on the basis of PAN. Non-financial transactions and demat transactions are not covered in CAS.
- CAS is sent on or before the 10th of every calendar month, where there is a financial transaction in the folio in the previous month. In case there is no transaction during the half-year, CAS is sent in the month following March or September.
- Unlike SoA and CAS, which shows the flow of unit-holding during the period, a Unit Certificate only confirms the number of units held in the name of the investor.
- In practice, open-end schemes issue SoA, while closed-end schemes issue Unit Certificates. Since physical units of open-end schemes are non-transferable, Unit

Certificate does not offer any real transactional convenience for the unit-holder. However, if a unit-holder asks for it, the AMC is bound to issue a Unit Certificate.

- 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.
- In the case of joint holding, every unit-holder will have to sign the nomination form. If one joint holder dies, then the units will continue to be held by the surviving joint holder/s.
- 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 inheritance laws applicable to the unit-holder too need to be considered by the investor.
- Banks, NBFCs and other financiers often lend money against pledge of Units by the Unit-holder. 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.

**Sample Questions**

- 1. For which of the following options within the scheme is the portfolio performance the same?**
  - a. Dividend payout and Dividend re-investment
  - b. Dividend payout and growth
  - c. Dividend re-investment and growth
  - d. Dividend payout, Dividend re-investment and Growth**
  
- 2. If there are no transactions in a folio, mutual funds issue Statement of Accounts every \_\_\_\_ month/s**
  - a. 1
  - b. 2
  - c. 3
  - d. 6**
  
- 3. Consolidated Account Statement is issued for**
  - a. Financial transactions**
  - b. Non-financial transactions
  - c. Demat transactions
  - d. All of the above
  
- 4. Post-demise transmission of units is facilitated through**
  - a. Nomination**
  - b. Pledge
  - c. ABSA
  - d. Demat

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## CHAPTER 10: ASSET CLASSES

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Investing in equity through mutual funds
- Investing in debt through mutual funds
- Investing in gold through mutual funds

Every mutual fund scheme or other investment product, gives the investor an exposure to one or more asset classes. One understands the investment product by understanding the kind of exposure it offers to the investor.

Equity, debt, gold and real estate are asset classes to which many investors have an exposure. Each asset class has its unique features.

### 10.1 Equity

Equity is a growth asset. Investment in equity shares of a company represents an exposure to the future profits and performance of the company.

Better the performance of the investee company, higher is likely to be the price at which its equity shares trade in the market. Investors can earn capital gains by selling their shareholding in the company at a higher price than their acquisition cost. However, if the investment does not work out, then the investor may have to book capital losses.

In order to minimise the possibility of losing money in equity investments, it is advisable that every investor spreads his investment across different industries (sectors). This is called *diversification*.

Investors can take equity exposure, either by buying equity shares of companies, or buying units of equity mutual fund schemes.

Direct investment in equity shares calls for an understanding of the performance and prospects of various companies. Such analyses are both time consuming and costly.

Besides, a diversified exposure would require buying shares of companies belonging to several sectors. This increases the number of transactions, and the amount that the investor has to invest.

When an investor buys units of a diversified equity scheme, he gets exposure to the various sectors that the scheme invests in. This is a very simple and convenient way for investors to take a diversified equity exposure with an investment that is as low as Rs 5,000.

Capital appreciation is a significant part of the returns that an investor hopes to earn from equity investments. The investor also earns an income in the form of dividends, which profitable companies and mutual fund schemes declare.

People invest in equities because it protects them from inflation. Over the long term, share prices appreciate faster than prices of goods and services.

Equities are also a volatile asset. The price of equity shares can fluctuate widely, even within a day. In order to minimise potential losses, equity investment is normally suggested only when the investor has an investment horizon of at least 3 to 5 years.

As an additional safeguard, investors are advised to build their equity portfolio over the long term, through the SIP route.

### 10.2 Debt

Debt is an income asset. A greater proportion of the income from debt comes in the form of interest income.

Debt is considered safer than equity because most debt securities have a maturity date on which the principal will be redeemed. Thus, subject to credit risk, investor in a debt security has an exit option that is not linked to the market.

Exposure to debt can be taken in various ways, such as bank deposits, company fixed deposits, post office deposits, PPF, NSC and debt mutual fund schemes.

Investors are advised to take a part of their debt exposure through debt mutual fund schemes, for the following reasons:

- Debt mutual fund schemes offer the possibility of capital appreciation. This is not possible with any of the other debt investment avenues mentioned above.

It is possible to lose money in debt mutual fund schemes, though that is less likely. Price risk can be minimised through liquid funds; credit risk can be eliminated through gilt funds; volatility of return on maturity can be minimised through FMP.

- In a declining interest rate scenario, investors earn lesser and lesser, when they invest their moneys in the regular debt investment products. This can disrupt the income streams and life style of retired investors, in particular.

In such situations of declining interest rate, debt portfolios appreciate. This boosts the NAV and wealth of the investor in debt mutual fund schemes. Thus, the conventional debt schemes are an effective hedge against declining interest rates.

- On the other hand, in an increasing interest rate scenario, floating rate schemes offer protection against any significant decline in the value of the portfolio. The portfolio keeps earning higher interest, as yields in the market go up.

- FMP is an interesting option, where the returns on maturity are less uncertain; yet, the investor retains the possibility of selling the units for a profit in the stock exchange. Investors can consider spreading their investments between bank deposits and FMP.
- People in business tend to have surplus funds in their current accounts, on which they do not earn any income. An investment in liquid funds yields a return; yet, it can be re-purchased to meet the investor's cash flow needs at short notice.
- The SIP route ensures a savings discipline in the investor.
- As discussed in Chapter 1, mutual funds offer the facility of growing the investor's portfolio on a gross basis, without having to pay a tax every year.

Even on redemption of units, the incidence of taxation can be minimised by structuring it as a long term capital gain. This is easily possible through a SWP.

- New investors can get familiar with mutual funds by investing in lower risk debt schemes. When they are comfortable, they can switch to equity schemes to build their long term wealth.

### 10.3 Gold

Gold is considered a safe haven asset. Its value appreciates when there is any turmoil in the world, usually. It therefore is a good hedge against losses in other investments that an investor may have.

Price of gold in India is determined by international prices of gold and the value of the rupee. An Indian investor in gold benefits, both, when international prices of gold go up, or the Indian rupee becomes weaker. Thus, investment in gold is an investment in a truly international asset.

In a situation where rupee becomes weaker, an Indian family finds it more challenging to send its children abroad for further studies. Appreciation in gold offers an effective hedge during such scenarios.

Gold is also an extremely liquid asset. It can be easily sold or pawned to meet cash flow needs anywhere in the country.

It is for these reasons, that investors are advised to take some exposure to gold, as part of their overall portfolio. Gold Index Funds and ETF gold are considered to be superior for taking such exposure because:

- Mutual fund units are safer. The investor is not exposed to risk of loss through theft or other contingencies. He can always ask for a duplicate statement of account or unit certificate. The investment can also be held in demat form.

- Investor does not need to spend on locker or other security requirements to protect his mutual fund investments.
- The investor does not have to worry about purity of gold either. That is the job of the AMC.
- There is complete transparency in investment transactions in gold mutual fund schemes. Sale and re-purchase of mutual fund units happen at prices determined by the NAV.
- Investor needs to pay wealth tax every year, on his physical gold holding. However, investment in mutual fund schemes is exempt from wealth tax.
- If an investor sells physical gold at a profit, it will be treated as short term capital gain, unless the gold has been held for at least three years.

Investment in mutual fund units needs to be held for only one year, to benefit from concessional taxation for long term capital gains.

- Gold ornaments, in particular, are a very inefficient form of investment in gold. Besides the worry about purity of gold, making charges and lack of transparency in pricing can prove costly for the investor.

### 10.4 Real Estate

A large portion of investible surplus is locked into real estate in the form of land, house, commercial office, warehouse and the like. The tangible nature of this asset class makes it attractive investment proposition across all classes of investor. Important to note that residential house is not considered as an investment asset.

Investment in real estate requires huge initial outlay, considered as a good hedge against inflation, the gestation period is high and a high risk- high return asset. Price discovery is difficult in real estate market in the absence of regulations and transparency in transactions. Efforts are made to put regulations in place for real estate industry.

### Summary

- Equity, debt and gold are asset classes to which many investors have an exposure.
- Equity is a growth asset. Investment in equity shares of a company represents an exposure to the future profits and performance of the company.
- In order to minimise the possibility of losing money in equity investments, it is advisable that every investor spreads his investment across different industries (sectors). This is called *diversification*.
- When an investor buys units of a diversified equity scheme, he gets exposure to the various sectors that the scheme invests in. This is a very simple and convenient way for investors to take a diversified equity exposure with an investment that is as low as Rs 5,000.
- People invest in equities because it protects them from inflation. Over the long term, share prices appreciate faster than prices of goods and services.
- Equities are also a volatile asset. The price of equity shares can fluctuate widely, even within a day.
- In order to minimise potential losses, equity investment is normally suggested only when the investor has an investment horizon of at least 3 to 5 years.
- Debt is an income asset. A greater proportion of the income from debt comes in the form of interest income.
- Debt is considered safer than equity because most debt securities have a maturity date on which the principal will be redeemed. Thus, subject to credit risk, investor in a debt security has an exit option that is not linked to the market.
- In situations of declining interest rate, debt portfolios appreciate. This boosts the NAV and wealth of the investor in debt mutual fund schemes. Thus, the conventional debt schemes are an effective hedge against declining interest rates.
- In an increasing interest rate scenario, floating rate schemes offer protection against any significant decline in the value of the portfolio. The portfolio keeps earning higher interest, as yields in the market go up.
- Gold is considered a safe haven asset. Its value appreciates when there is any turmoil in the world. It therefore is a good hedge against losses in other investments that an investor may have.
- Price of gold in India is determined by international prices of gold and the value of the rupee. An Indian investor in gold benefits, both, when international prices of gold go up, or the Indian rupee becomes weaker.

- Gold is also an extremely liquid asset. It can be easily sold or pawned to meet cash flow needs anywhere in the country.
- Investor needs to pay wealth tax every year, on his physical gold holding. However, investment in mutual fund schemes is exempt from wealth tax.
- If an investor sells physical gold at a profit, it will be treated as short term capital gain, unless the gold has been held for at least three years.
- Investment in mutual fund units needs to be held for only one year, to benefit from concessional taxation for long term capital gains.
- One can invest in real estate by investing in land, residential flat, commercial office, REIT, etc.
- Residential house is not considered as an investment asset.
- Investing in real estate requires huge initial investment.
- Property transactions lack transparency and standardization.
- Return from real estate surpassed inflation over longer time frames.

**Sample Questions**

1. **A greater portion of returns from equity asset class is generally through**
  - a. **Capital gain**
  - b. Interest income
  - c. Dividend income
  - d. Inflation
  
2. **In declining interest rate scenario, which of the following is better?**
  - a. Conventional debt investments like bank deposits
  - b. **Conventional debt schemes**
  - c. Floaters
  - d. Gold schemes
  
3. **A greater portion of returns from conventional debt investments is generally through**
  - a. Capital gain
  - b. **Interest income**
  - c. Dividend income
  - d. Inflation
  
4. **\_\_\_\_\_ is a safe haven asset class**
  - a. Debt
  - b. **Gold**
  - c. Equity
  - d. Real Estate

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## CHAPTER 11: FINANCIAL PLANNING CONCEPTS

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Meaning of Financial planning
- Assessment of financial goals and planning investment horizons
- Objectives and benefits of financial planning
- Goal oriented financial planning

### 11.1 Introduction to 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 10th 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.

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.

### 11.2 Assessment of Financial Goals

In the above example, 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:

- 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 is likely to be the rise in expense 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:

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%

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 calculations can be done using a normal calculator. If it has the 'exponential' (EXP or x<sup>y</sup>) function, then the calculations become easier.

For instance, the requirement of Rs 120,000 in terms of today's money value, translates into a rupee requirement in 2 years of:

$$(1 + 7\%) \text{EXP} 2 \times 120,000$$

The answer is Rs 137,388.

The same exercise done for the other year's expenses gives a year-wise future requirement in rupee as follows:

Year	Entries in Calculator	Future Requirement(Rs)
1	(1 + 7%)EXP 1 X 100,000	107,000
2	(1 + 7%)EXP 2 X 120,000	137,388
3	(1 + 7%)EXP 3 X 1,000,000	1,225,043
4	(1 + 7%)EXP 4 X 500,000	655,398
5	(1 + 7%)EXP 5 X 500,000	701,276
6	(1 + 9%)EXP 6 X 500,000 (7% domestic inflation + 2% on account of rupee getting weaker)	838,550

These are the financial goals that need to be met, in order to realize the aspiration of seeing the son become a doctor.

### 11.3 Investment Horizon

The year-wise financial goals statement throws up the investment horizon. It would be risky to expect the first three to five years expenses to be met out of equity investments being made today. But equity is a viable investment option for expenses beyond that period.

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.

### 11.4 Assessing Investment Requirement

Suppose the investor is comfortable about meeting Rs100,000 of the expense each year. The balance would need to be provided out of investments being made today. How much is that investment requirement? 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:

Yr	Required in future (Rs)	Regular Savings (Rs)	Balance Required (Rs)	Calculation <sup>^</sup>	Investment Required Today (Rs)
1	107,000	100,000	7,000	=7000/ (1+6%) <sup>1</sup>	6,604
2	137,388	100,000	37,388	=37388/ (1+6%) <sup>2</sup>	33,275
3	1,225,043	100,000	1,125,043	=1125043/ (1+6%) <sup>3</sup>	944,608
4	655,398	100,000	555,398	=555398/ (1+9%) <sup>4</sup>	393,458
5	701,276	100,000	601,276	=601276/ (1+9%) <sup>5</sup>	390,788
6	838,550	100,000	738,550	=7000/ (1+9%) <sup>1</sup>	440,373
<b>Total</b>					<b>22,09,106</b>

^ You may have to first calculate the denominator using the exponential function, store it in memory and then divide the numerator by the number in the memory. Make sure you clear the memory after the calculation for each year.

Suppose:

$\boxed{C}$  is the key to clear the value in the screen,  
 $\boxed{M+}$  is the key to add a value to the memory,  
 $\boxed{MR}$  is the key to use the value in the memory and  
 $\boxed{MC}$  is the key to clear the value in the memory.

The first value in the table can be calculated as follows:

$$(1+6\%) \boxed{EXP} 1 \boxed{M+C} 7000 \div \boxed{MR} =$$

This will give the value 6604. Note down the number and enter  $\boxed{MC}$  before proceeding to the next calculation.

[The functions vary between calculators. The above is an example of what is possible with most calculators. The calculation can also be entered in spreadsheet packages like MS Excel]

Thus, a total amount of Rs 22,09,106 needs to be invested right now with Rs 984,487 in debt with upto 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.

Many AMC's and websites offer calculators that help with the above calculations.

### 11.5 Financial Planning Objectives & 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.

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" as compared to 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.

The financial planner may also suggest a loan to meet the heavy expense of Year 3. 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.

### **11.6 Goal Oriented Planning and Comprehensive Financial Plan**

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 are worked out on that basis.

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.

## **Summary**

- 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.
- The costs mentioned above, in today's terms, need to be translated into the rupee requirement in future. This is done using the formula  $A = P \times (1 + i)^n$
- The year-wise financial goals statement throws up the investment horizon. It would be risky to expect the first three to five years expenses to be met out of equity investments being made today.
- 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.
- A "goal-oriented financial plan" is a financial plan for a specific goal e.g. 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.
- 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.

**Sample Questions**

- 1. An expense of Rs 50,000 in today's money terms is likely to be required in 3 years. Inflation is expected at 10%. How much will be the future requirement of money?**
  - a.  $50000 \times (1 + 10\%)^3$
  - b.  $50000 / (1 + 10\%)^3$
  - c.  $50000 + (1 + 10\%)^3$
  - d.  $50000 - (1 + 10\%)^3$
  
- 2. All financial goals are taken together in**
  - a. Goal-oriented planning
  - b. SIP
  - c. **Comprehensive financial plan**
  - d. Wealth management
  
- 3. Year-wise cash flows going several years into future is a feature of comprehensive financial plan**
  - a. **True**
  - b. False

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## CHAPTER 12: HELPING INVESTORS WITH FINANCIAL PLANNING

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- Steps of Financial planning
- Profiling of Investors according to--life cycle, wealth cycle, risk appetite
- Concept of asset allocation
- Building different kinds of model portfolios
- Selecting different mutual funds scheme according to the scheme objective
- Sources of data for tracking mutual fund schemes
- Different kinds of financial planning tools

### 12.1 Financial Planning Steps

Certified Financial Planner – Board of Standards (USA) proposes the following steps in financial planning:

- 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

### 12.2 Life Cycle

The life cycle of the client has a key role in his financial plan. The following are normal stages that people go through in life:

- **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. 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. A few get on to high-paying salaries early in their career. Others toil their way upwards. Either way, the person needs to get into the habit of saving. The fortunate few who start off well have to avoid falling into the trap of unsustainable life styles.

Equity SIPs are a great way to force the young unmarried into the habit of regular savings, rather than lavish the money away.

This is the right age to start investing in equity. 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. Others have the luxury of not having to provide much for liquidity needs. Accordingly, the size of the equity portfolio is determined.

- **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, but not so critical.

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 premium can be an issue, competing with other basic needs of food, clothing and shelter. Term insurance (where premium is lower) possibilities have to be seriously explored and locked into.

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 medical 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-imbursment from the insurer. This increases the liquidity provisions that need to be made for contingencies by the policy holder.

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 for both life and health cover 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.

- **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.

- **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 and not to meet regular expenses.

The availability of any pension income and its coverage (only for the pensioner or survivor 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.

### 12.3 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 assist 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 health 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 regular money. 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 instances of sudden wealth. 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. Such strategies need to be suggested, considering the unique situation of the investor.

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 of sudden wealth.

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.

### 12.4 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 prerequisite 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

Some of the factors and their influence on risk appetite are as follows:

Factor	Influence on Risk Appetite
<b><i>Family Information</i></b>	
• 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
<b><i>Personal Information</i></b>	
• 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
<b><i>Financial Information</i></b>	
• 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?”

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.

### 12.5 Asset Allocation

‘Don’t put all your egg in one basket’ is an old proverb. It equally applies to investments. Asset allocation may not give the investor the best return available in the market, but the investor will not also get the worst returns or see his capital getting wiped off.

Risk and return in various asset classes (equity, debt, gold etc.) are driven by different factors. This was discussed in Chapter 10.

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. Investment in only gold would have given even better returns, but it is not possible to consistently identify the single asset class that will offer the best returns over the investment horizon. Hence, there is a need to distribute an investor’s portfolio between different asset classes. Such distribution between asset classes is *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.

### 12.6 Model Portfolios

Since investors’ risk appetites vary, a single portfolio cannot be suggested for all. Financial planners often work with model portfolios to ascertain 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; 15% gold ETF, 15% gilt fund, 15% diversified debt fund, 20% liquid schemes.

- **Couple in their seventies, with no immediate family support**

15% diversified equity index scheme; 10% gold ETF, 30% gilt fund, 30% diversified debt fund, 15% liquid schemes.

As the reader would appreciate, these percentages are illustrative and subjective. The emphasis is on ensuring that the financial planner has a model portfolio for every distinct client profile. This can be tweaked around based on specific investor information.

Thus, a couple in their seventies, with no immediate family support but very sound physically and mentally, and a large investible corpus might be advised the following portfolio, as compared with the previous model portfolio:

20% diversified equity scheme; 10% diversified equity index scheme; 10% gold ETF, 25% gilt fund, 25% diversified debt fund, 10% liquid schemes.

## **12.7 Contingency Funds**

Financial planning should also provide for liquidity to meet contingencies that the investor might face. For example, he may lose his job. If, for a few months, the investor does not receive a regular income, how will the subsistence needs be met? This is the reason that contingency funds are provided in the financial plan.

The contingency funds should help the investor tide over loss of income for a few months. An investor who is likely to get alternate jobs very quickly may require contingency funds equivalent to 3-4 months of normal expenses. However, an investor with skills that have limited role in the market may require contingency funds equivalent to 9-12 months of normal expenses. The contingency funds need to be parked in debt assets that can be quickly and efficiently sold to generate the liquidity. Liquid funds and bank deposits are ideally suited for parking the contingency funds.

## **12.8 Scheme Selection**

Within each scheme category, specific schemes and options need to be identified. Factors that go into scheme selection depend on the type of schemes.

**Note:** This Workbook is meant for certification of distributors who will be eligible to sell only simple and performing mutual fund schemes.

This section compares the simple schemes with some other schemes, so that the distributor is adequately equipped to highlight the risk inherent in different types of schemes and gain easier acceptability among clients.

### **12.8.1 Equity Schemes**

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.

How long is long? Investing in equities with a horizon below 2 years can be dangerous. Ideally, the investor should look at a minimum of 3 to 5 years. With an investment horizon of 5 years and above, the probability of losing money in equities is negligible. Chances are that within this 5 year horizon, the investor will have at least one window of opportunity, to sell the equity investments for an attractive return.

The role of various broad equity scheme categories in an investor's portfolio is as follows:

- **Active or Passive**

As seen in Chapter 3, index funds are passive funds. They are expected to offer a return in line with the market. An investor in an active fund is bearing a higher cost for the fund management, and a higher risk. Therefore, 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, there is a risk 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 benchmark 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-end 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 trade. Screen-based trading enables this, but there is no guarantee that a trade will happen.

The price of units of a closed-end scheme in the stock exchange tends to be lower than the NAV. There is no limit to this discount. Only towards the maturity of the scheme, the market price converges towards the NAV.

Units of an open-end scheme will be bought back by the scheme at the NAV less Exit Load. This facility makes them more liquid than closed-end schemes. In order to provide this liquidity facility to investors, open-end 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 seeks to ensure higher exposure to the better performing sectors. An investor, investing or taking money out of a sector fund has effectively taken up the role of making the sector choices.

Diversified funds should be part of the core portfolio of every investor. Investors who are comfortable with risk can invest in sector funds. Further, an investor should have the skill to make the right sector choices, before venturing into sector funds.

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.

At any point of time, an investor in sector funds should have exposure to not more than 3 to 5 different sectors. Investing in more sectors than that, would amount to having a diversified portfolio of sector funds. The investor can save a lot of time by investing in a diversified fund instead!

- **Fund Size**

The size of funds needs to be seen in the context of the proposed investment universe. Thus, a sector fund with net assets of Rs 1,000crore, is likely to find investment challenging if all the companies in the sector together are worth only about Rs 10,000crore. On the other hand, too small a fund size means that the scheme will not benefit from economies of scale.

- **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 can also be indicative of unsteady investment management.

### 12.8.2 Debt Funds

Debt funds are less risky than equity funds for the reasons discussed in the Chapter 10.

These can be structured in various ways to meet useful investor needs. Some of these structures, and their benefits and risks to investors were discussed in Chapter 3.

- **Regular Debt Funds v/s MIPs**

MIP has an element of equity in its portfolio. Investors who do not wish to take any equity exposure, should opt for a regular debt fund.

- **Open-end Funds v/s FMP**

FMP is ideal when the investor's investment horizon is in sync with the maturity of the scheme, and the investor is looking for a return that is superior to what is available in a fixed deposit, yet not entirely uncertain. The portfolio risk discussed in Chapter 10 needs to be considered too.

An investor who is likely to require the funds anytime, would be better off investing in a normal open-end debt fund.

- **Gilt Funds v/s Diversified Debt Funds**

Diversified debt funds invest in a mix of government securities (which are safer) and non-government securities (which offer higher yields, but are subject to credit risk). A diversified mutual fund scheme that manages its credit risk well can generate superior returns, as compared to a Gilt Fund.

- **Long-Term Debt Fund v/s Short Term Debt Fund**

As discussed in the previous unit, the value of longer term debt securities fluctuates more than that of shorter term debt securities. Therefore, NAVs of long-term debt funds tend to be more volatile than those of short-term debt funds.

It was also seen that as yields in the market go down, debt securities gain in value. Therefore, long term debt funds would be sensible in declining interest rate scenarios. However, if it is expected that interest rates in the market would go up, it would be safer to go with Short Term Debt Funds (or Floaters).

- **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 lower. The comparable for a liquid scheme in the case of retail investors is a savings bank account. Switching some of the savings bank deposits into liquid schemes can improve the returns for him. Businesses, which in any case do not earn a return on their current account, can transfer some of the surpluses to liquid schemes.

It is not advisable to keep all of one's moneys in a savings bank account; some money needs to go into fixed deposits in order to improve returns; similarly, all of one's mutual fund investments should not be in liquid schemes. There is a need to invest in other debt schemes and also equity schemes.

Schemes that are named 'liquid plus' are not more liquid. They try to earn a higher return by investing in securities of a longer tenor than the regular liquid schemes. As the tenor increases, risk too increases. In order to prevent potential mis-selling, SEBI has now disallowed the use of the term 'liquid plus' as a fund type.

### 12.8.3 General Points on Scheme Selection

All the 41 AMCs that are currently 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. AMCs share the portfolio of all their schemes in their website on a monthly basis.

Equity investors would like to convince themselves that the sectors and companies where the scheme has taken higher exposure, are sectors / companies that are indeed promising.

Long-term watchers of mutual fund performance also develop views on AMCs/ Fund Managers that are more prescient in identifying changes in market trends.

Debt investors should ensure that the weighted average maturity of the portfolio is in line with their view on interest rates viz. Higher weighted average maturity during periods of declining interest rates; lower weighted average maturity, and higher exposure to floating rate instruments during periods of rising interest rates.

Investors in non-gilt debt schemes should 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.

Some other parameters that are considered while selecting schemes within a category, are as follows:

- **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 an undistinguished track-record is definitely avoidable.

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.

- **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.

- **Tracking Error**

Amongst index schemes, tracking error is a basis to select the better scheme. Lower the tracking error, the better it is. Similarly, Gold ETFs need to be selected based on how well they track gold prices.

- **Regular Income Yield in Portfolio**

Schemes' income comes out of regular income (dividend income in equity portfolio, interest income in debt portfolio) and capital gains. Regular incomes are seen as a more stable source of income than capital gains. Therefore, a high regular income yield is a strong positive for a scheme.

Risk, return and risk-adjusted returns as parameters to evaluate schemes were discussed in Chapter 4. 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 scheme categories that have fewer 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.

### 12.9 Selecting Options 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/ redemption 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) for tax reasons that are unique to them.

Re-purchase transactions in equity schemes are subject to STT. Further, there is no dividend distribution tax on equity schemes. Therefore, subject to the unique tax benefits 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 (MIP), dividend declaration is a function of distributable surplus. If there is no surplus to distribute, dividend cannot be declared. Therefore, 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 is 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 would 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 or even nil, it is meaningless to bear the cost of distribution tax. 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 for investors having income higher than the minimum exemption limit.

Thus, taxation and liquidity needs are a factor in deciding between the options. The advisor needs to understand the investor's situation before advising.

### **12.10 Sources of Data to Track Mutual Fund Schemes**

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 on their websites. Using these, the

performance of schemes, their ranking, rating etc. and comparison of performance between specific schemes, is easy to ascertain.

The mix of free and paid content in the industry is subject to change. The following are some of the agencies that are in this field:

- Credence Analytics ([www.credenceanalytics.com](http://www.credenceanalytics.com))
- CRISIL ([www.crisil.com](http://www.crisil.com))
- Lipper ([www.lipperweb.com](http://www.lipperweb.com))
- Morning Star ([www.morningstar.com](http://www.morningstar.com))
- Value Research ([www.valueresearchonline.com](http://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.

### **12.11 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 in regular monitoring of the portfolio.

A few mutual funds and securities companies provide 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.

### Summary

- Certified Financial Planner - Board of Standards (USA) proposes the following steps in financial planning:
  - 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 life cycle of the client has a key role in his financial plan. The stages include childhood, young-unmarried, young-married, married with young children, married with older children, pre-retirement and retirement.
- Parents and seniors need to groom children to imbibe the virtues of savings, balance and prudence.
- Equity SIPs are a great way to force the young unmarried into the habit of regular savings, rather than lavish the money away.
- Where only one spouse is working, life insurance to provide for contingencies associated with the earning spouse are absolutely critical.
- Term insurance policies provide cover at the lowest cost.
- 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
- On retirement, 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.
- Wealth cycle is an alternate approach to profile the investor's position. The stages are accumulation, transition, inter-generation transfer, distribution and sudden wealth.
- There are differences between investors with respect to the levels of risk they are comfortable with (risk appetite).
- Risk profiling is an approach to understand the risk appetite of investors - an essential pre-requisite to advise investors on their investments.
- Some AMCs and securities research houses provide risk profiling tools in their website. Some banks and other distributors have proprietary risk profilers.

- 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.
- Financial planners often work with model portfolios – the asset allocation mix that is most appropriate for different risk appetite levels.
- 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.
- An investor in an active fund is bearing a higher cost for the fund management, and a higher risk. Therefore, 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.
- The significant benefit that open-end funds offer is liquidity viz. the option of getting back the current value of the unit-holding from the scheme.
- A closed-end scheme offers liquidity through a listing in a stock exchange. Unfortunately, mutual fund units are not that actively traded in the market.
- The price of units of a closed-end scheme in the stock exchange tends to be lower than the NAV. There is no limit to this discount. Only towards the maturity of the scheme, the market price converges towards the NAV.
- Open-end schemes are 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 funds should be part of the core portfolio of every investor. Investors who are comfortable with risk can invest in sector funds. Further, an investor should have the skill to make the right sector choices, before venturing into sector funds.
- At any point of time, an investor in sector funds should have exposure to not more than 3 - 5 different sectors.
- MIP has an element of equity in its portfolio. Investors who do not wish to take any equity exposure, should opt for a regular debt fund.
- 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 return that is superior to what is available in a fixed deposit, yet not entirely uncertain.
- A diversified mutual fund scheme that manages its credit risk well can generate superior returns, as compared to a gilt Fund.
- NAVs of long-term debt funds tend to be more volatile than those of short-term debt funds.

- An investor seeking the lowest risk ought to go for a liquid scheme. However, the returns in such investments are lower.
- Debt investors would ensure that the weighted average maturity of the portfolio is in line with their view on interest rates viz. higher weighted average maturity during periods of declining interest rates; lower weighted average maturity, and higher exposure to floating rate instruments during periods of rising interest rates.
- 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.
- 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 fewer schemes; or the top 10-15%, in categories where there are more schemes.
- Re-purchase transactions in equity schemes are subject to STT. Further, there is no dividend distribution tax on equity schemes. Therefore, subject to the unique tax benefits 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.

**Sample Questions**

- 1. According to Certified Financial Planner - Board of Standards (USA), which of the following is the first stage in financial planning?**
  - a. Establish and Define the Client-Planner Relationship**
  - b. Gather Client Data, Define Client Goals
  - c. Analyse and Evaluate Client's Financial Status
  - d. Develop and Present Financial Planning Recommendations and / or Options
  
- 2. Maximum ability to take risk is in accumulation phase**
  - a. True**
  - b. False
  
- 3. A significant benefit of open-end schemes is**
  - a. Low cost
  - b. Better portfolio
  - c. Superior returns
  - d. Liquidity**
  
- 4. Before maturity, closed-end units tend to quote in the stock exchange below their NAV.**
  - a. True**
  - b. False

## CHAPTER 13: LEGAL & REGULATORY ENVIRONMENT

### LEARNING OBJECTIVES:

After studying this chapter, you should know about:

- SEBI and its regulations related to mutual funds
- AMFI and its role in the mutual fund industry
- Concept of Expense Limit
- Investors Rights and Obligations

### 13.1 SEBI

SEBI regulates the capital markets including mutual funds, other 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 relevant sections of this Workbook.

Some segments of the financial markets have their own independent regulatory bodies. Wherever applicable, mutual funds need to comply with such 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.

### 13.2 AMFI

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].

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 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 agents/ distributors and to implement a programme of training and certification for all intermediaries and others engaged in the industry.
- To undertake nationwide investor awareness programmes 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.

As discussed in Chapter 7, AMFI has introduced ACE to promote higher standards among AMC's and AGNI to enhance the standards of conduct among intermediaries.

### 13.3 Expense Limits

As a measure of investor protection, SEBI has set limits on the recurring expenses that can be levied in the scheme. The recurring expense cannot go higher than 2.5% of AUM for equity schemes, and 2.25% of AUM for debt schemes. This limit goes down as the scheme AUM increases.

Service tax on AMC fees can be charged in addition to the above limit.

Further, schemes are permitted to additionally charge upto 0.30% of AUM, depending on how much they mobilise from locations beyond the top 15 cities in the country. This additional expense limit however needs to be reversed if the investment is redeemed within a year.

### 13.4 Investors' Rights

#### 13.4.1 Minimum Service Standards from Mutual Funds

- Schemes, other than ELSS and RGESS, need to allot units or refund moneys within 5 business days of closure of the NFO.
- 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.
  - In the case of post-NFO investment - within 10 working days of the investment
  - 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.

- Units of all mutual fund schemes held in demat form are freely transferable.

Only in the case of ELSS Schemes, free transferability of units (whether demat or physical) is curtailed for the statutory minimum holding period of 3 years. Similarly, there are restrictions to transfer of RGESS Schemes during the minimum holding period.

- Investor can ask for a Unit Certificate instead of the Statement of Account that is normally issued to investors in open-end schemes.
- NAV has to be published daily, in at least 2 newspapers.
- NAV and re-purchase price are to be updated in the website of AMFI and the mutual fund 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.

### 13.4.2 Other Rights of Investors

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

If a unit holder holds 5% of the units issued by a scheme, he has beneficial interest in 5% of the scheme's net assets.

- Investors can choose to change their distributor or go direct. 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 DP is 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 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, closed-end / 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, R&T agent 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 the mutual fund's Annual Report.

- Scheme-wise Annual Report, or an abridged summary has to be mailed (physical copy) to all unit-holders whose e-mail ID is not available, within 6 months of the close of the financial year.

Where e-mail ID is available, it is to be e-mailed. It is also available as a download in the mutual fund website. However, every investor has a right to ask for a physical copy.

- 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 a transparent process is followed. This process includes proper disclosure to investors and a time period of one month given for dissenting investors to exit from the scheme at NAV i.e. without having to incur any exit load.
- 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.

### 13.4.3 Unclaimed Amounts

The mutual fund has to deploy unclaimed dividend and redemption amounts in the money market. Investor can recover the moneys that belong to him, 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.

### 13.4.4 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.

### **13.5 Investors' Obligations**

PAN No. and KYC documentation are compulsory for mutual fund investments. Only exception is micro-SIPs.

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

### **13.6 Can a Mutual Fund Scheme Fail?**

A mutual fund scheme may fail to meet its objectives. Its returns may be lower than the market. However, the net assets of the scheme belong completely to the unit-holders.

While the AMC manages the investments of the scheme, the assets of the scheme are held by the custodian. The custodian is independent of the sponsor and the AMC. The AMC and custodian 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 the case of shares and fixed deposits, mutual funds cannot vanish.

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 in the running of mutual funds.

### Summary

- SEBI regulates the capital markets including mutual funds, other funds, depositories, custodians and registrars & transfer agents in the country.
- 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.
- Anyone who is aggrieved by a ruling of SEBI, can file an appeal with the Securities Appellate Tribunal.
- AMCs in India are members of AMFI, an industry body that has been created to promote the interests of the mutual funds industry.
- SEBI has set limits on the recurring expenses that can be levied in the scheme. The recurring expense cannot go higher than 2.5% of AUM for equity schemes, and 2.25% of AUM for debt schemes. This limit goes down as the scheme AUM increases. Service tax on AMC fees can be charged in addition to the above limit. Further, schemes are permitted to charge upto 0.30% of AUM higher, depending on how much they mobilise from locations beyond the top 15 cities in the country.
- 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.
- 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.
- Unit-holders have proportionate right to the beneficial ownership of the net assets of the scheme.
- The mutual fund has to publish a complete statement of the scheme portfolio and the unaudited financial results, within 1 month from the close of each half year.
- Debt-oriented, closed-end / interval, schemes / plans need to disclose their portfolio in their website every month, by the 3rd working day of the succeeding month.
- Scheme-wise Annual Report, or an abridged summary has to be mailed (physical copy) to all unit-holders whose e-mail ID is not available, within 6 months of the close of the financial year.
- Where e-mail ID is available, it is to be e-mailed. It is also available as a download in the mutual fund website. However, every investor has a right to ask for a physical copy.

- The trustees / AMC cannot make any change in the fundamental attributes of a scheme, unless a transparent process is followed.
- 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.

**Sample Questions**

- 1. Mutual funds investing in money market instruments need to comply with**
  - a. SEBI requirements
  - b. RBI requirements
  - c. Both (a) and (b)**
  - d. None of the above
  
- 2. Anyone aggrieved with a ruling of SEBI can approach the Securities Appellate Tribunal.**
  - a. True**
  - b. False
  
- 3. Dividend warrants have to be dispatched to investors within 30 days of declaration of the dividend**
  - a. True**
  - b. False
  
- 4. Debt oriented schemes need to disclose their portfolio in their website every month, by the \_\_\_\_ working day of the succeeding \_\_\_\_.**
  - a. 3<sup>rd</sup>, month**
  - b. 3<sup>rd</sup>, quarter
  - c. 7<sup>th</sup>, month
  - d. 7<sup>th</sup>, quarter

### Indicative Reading List

- Bogle John C, "Bogle on Mutual Funds", Dell Publishing
- Bogle John C, "Common Sense on Mutual Funds", John Wiley & Sons
- Fredman & Wiles, "How Mutual Funds Work", Prentice-Hall
- Gibson Roger C, "Asset Allocation – Balancing Financial Risk", Tata McGraw Hill
- Income Tax Ready Reckoner (Latest)
- Jacobs Bruce, "All about Mutual Funds", Probus Publishing
- Mutual Funds Guide 2012, Value Research
- Pozen Robert C, "The Mutual Fund Business", The MIT Press
- Rowland Mary, "The New Commonsense Guide to Mutual Funds", Vision Books
- Sadhak H, "Mutual Funds in India", Response Books / Sage Publications
- SEBI, Investor Grievances - Rights & Remedies
- Scott David L, "How to Manage Your Investment Risks and Returns", Vision Books
- Sundar Sankaran, "Indian Mutual Funds Handbook", Vision Books (2012 3rd edition)
- Sundar Sankaran, "Wealth Engine: Indian Financial Planning & Wealth Management Handbook", Vision Books (2012)

### Indicative Browsing List

- AMFI ([www.amfiindia.com](http://www.amfiindia.com))
- BSE ([www.bseindia.com](http://www.bseindia.com))
- Care Ratings ([www.careratings.com](http://www.careratings.com))
- Credence Analytics ([www.credenceanalytics.com](http://www.credenceanalytics.com))
- CRISIL ([www.crisil.com](http://www.crisil.com))
- ICRA ([www.icra.in](http://www.icra.in))
- IRDAI ([www.irda.gov.in](http://www.irda.gov.in))
- Lipper ([www.lipperweb.com](http://www.lipperweb.com))
- MCX-SX ([www.mcx-sx.com](http://www.mcx-sx.com))
- Morning Star ([www.morningstar.com](http://www.morningstar.com))
- Mutual Fund India ([www.mutualfundindia.com](http://www.mutualfundindia.com))
- NSE ([www.nseindia.com](http://www.nseindia.com))
- PFRDA ([www.pfrda.org.in](http://www.pfrda.org.in))
- RBI ([www.rbi.org.in](http://www.rbi.org.in))
- SEBI ([www.sebi.gov.in](http://www.sebi.gov.in)) - Mutual Funds Section
- Value Research ([www.valueresearchonline.com](http://www.valueresearchonline.com))

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**Note:** The above mentioned Reading and Browsing list is only indicative and is provided only as a guide to readers.

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