Role of Mutual Funds in Indian Economy: An Empirical Analysis

Dr.Lokesha M N
Assistant Professor of Economics, Govt. First Grade College, Channarayapatana, Hassan (Karnataka) India

Abstract: Ordinary investors often lack the ability and information required to invest directly in the stock market in India. As a result, they frequently lose money due to poor stock selection or investment decisions. Mutual funds, however, can provide professional investment management expertise and diversify risk by pooling investments from multiple investors and spreading them across various stocks and debt instruments. This can help investors earn good returns at a relatively lower risk compared to direct stock market investments. Mutual funds are particularly beneficial for investors who either lack the large sums of capital needed for direct investing or do not have the knowledge or time to research the market extensively, but still want to grow their wealth. To access this professional management, investors pay a small fee to the fund house, which is deducted from their investment.

Key Words: Investment decisions, financial management, stocks and fortfolio.

INTRODUCTION

Over the past decade, the economy has experienced significant changes, especially within the financial sector, which has been subject to various structural reforms. These reforms were largely prompted by poor financial management and the adverse economic circumstances prevailing in the country. The situation was further complicated by the Gulf War and the increasing debt burden that the nation faced. As a result, the reform process initiated in 1991 aimed to revamp the financial sector with goals such as simplifying procedures, encouraging both domestic and international investment, improving fiscal management, and revising foreign exchange regulations. This reform effort began in 1991 under significant pressure, as the country complied with the stipulations imposed by the International Monetary Fund (IMF), due to the absence of feasible alternatives.

The International Monetary Fund (IMF) has underscored the importance of progressively replacing public investment with private investment, advocating for a systematic increase in private sector involvement. Furthermore, the IMF urged the removal of all structural and procedural obstacles that impede foreign investments from entering the nation. The first mutual fund in India was established in 1963, with the Government of India founding the Unit Trust of India (UTI). UTI held a dominant position in the Indian mutual fund industry until 1987, when various other government-affiliated financial institutions, including the State Bank of India, Canara Bank, and Punjab National Bank, introduced their own funds. The primary objective was to drive rapid economic growth through investment, utilizing the economic concepts of the multiplier and accelerator effects. Historically, the infrastructure sector in India received minimal focus during earlier reform phases; however, it became clear that true globalization could not be achieved without infrastructure advancement. Enhanced investment required a robust capital market. During the 1990s, the capital market not only gained prominence but also offered smaller and individual investors opportunities to engage in stock investments. Mutual Funds (MFs) have emerged as a vital element of the capital market and play an essential role in India's post-reform landscape.

Mutual funds in India began to flourish in the early 1990s, and currently, numerous institutions and corporate groups manage their own funds within the country. Notable entities include the Unit Trust of India (UTI), Life Insurance Corporation of India (LIC), State Bank of India (SBI), General Insurance Corporation (GIC), Housing Development Finance Corporation (HDFC), Canara Bank, Tata Group, Birla Group, and Reliance Group, among others. UTI remains the leading mutual fund provider due to its extensive network throughout the nation. Mutual funds facilitate a connection between primary and secondary markets for investors, especially benefiting small and individual investors. The industrial growth has led to a significant rise in stock values, prompting the average person to seek investment opportunities in the stock market. However, the current stock exchanges are limited to a few major cities, leaving many investors in remote areas without direct access to these markets.

Furthermore, a significant number of individuals do not possess the necessary knowledge to make informed decisions regarding stock investments, which creates a demand for specialized guidance in this area. Although mutual funds are accessible in the market, fewer than 10% of Indian households have chosen to invest in them. A recent study on Mutual Fund Investments in India, conducted by Boston Analytics, indicates that potential investors are hesitant to allocate their funds to mutual funds due to concerns about perceived risks and a lack of understanding of their operational mechanisms. As of June 2013, there were 46 mutual funds available. (Goetzmann, William N: 2015: 66)

Most individual investors looking to invest in stocks prefer to avoid engaging in high-risk and speculative trading. Instead, the vast majority of small investors seek sound investment strategies that offer tax benefits and the highest possible returns. Mutual funds provide this opportunity for individual and small investors. By reviewing their performance history, investors can make informed decisions about which funds to choose. Typically, mutual funds are managed by a team of experts who analyze market conditions and determine the best investment strategies for their portfolios. These funds may invest in promising new companies or established firms that are already performing well.

REVIEW OF LITERATURE

Akinchan Buddhodev Sinha (2006), This article aims to explore the mutual fund industry's performance during the global financial crisis, conduct a SWOT analysis, and assess its sustainability. They stated that after overcoming various obstacles, mutual funds have become an integral part of the Indian financial framework and emerged as a preferred investment destination for investors seeking better returns on their excess funds. The concept of portfolio management, which was previously unfamiliar to many investors, has gained significant importance with the introduction of diverse mutual fund schemes. The mutual fund industry has witnessed the proliferation of various Asset Management Companies (AMCs). In this context, it is crucial to understand the general functioning of AMCs from a perspective beyond the commonly considered factors, such as Net Asset Value (NAV), portfolio returns, and systematic risks. Typically, investors, both existing and potential, assess an AMC based on the NAV and returns of its various schemes. However, it is equally important to evaluate the mutual fund industry and an AMC from other perspectives as well.

Dr. Barun Kumar Das (2011) , The mutual funds industry in India has its origins in the establishment of the Unit Trust of India (UTI through the UTI Act of 1963. Despite facing various challenges, the UTI has maintained a prominent position in the mutual funds industry. Over the past two decades, the entry of public sector banks and both domestic and foreign insurance companies has led to significant growth in India's mutual funds industry. Investors now commonly rely on mutual funds as an investment option that offers potential for growth with relatively lower risk compared to direct investment in stocks.

Rajesh Chakrabarti (2007), This study investigates the geographical penetration and distribution of mutual funds in India, as well as the key factors influencing these. Using survey data collected from fund managers, the analysis provides both qualitative and quantitative insights into the nature and determinants of mutual fund presence across the country. The findings suggest that distribution channels play a crucial role in fund penetration, and that focusing on facilitating these channels may be a more effective approach than solely relying on investor education to drive increased mutual fund

Types of Mutual Funds

Different classifications of mutual funds are

I. Mutual Funds Can Be Classified Into Different Types Based On Their Structure:

1. Close-ended Schemes:

These funds have a fixed maturity period, and new units are only issued during the initial New Fund Offer (NFO). After the NFO, the units are listed on stock exchanges, allowing investors to trade them before maturity. On maturity, the fund is dissolved, and investors receive the Net Asset Value (NAV) of their units. Close-ended funds have relatively lower volatility in NAV, as cash inflows and outflows are restricted. These funds are suitable for long-term investors looking to park a substantial amount for an extended period.

2. Open-ended Schemes:

Units of these funds can be bought and sold even after the NFO period. Investors can purchase or redeem units as per their convenience, and there is no limit on the number of units that can be issued. Open-ended funds offer high liquidity, as investors can sell their units at the prevailing NAV. Investors can also utilize systematic investment or withdrawal plans with open-ended funds. These funds are appropriate for investors seeking a highly liquid investment option and are willing to take moderate to high risk.

3. Interval Schemes:

Interval funds are a hybrid of open-ended and close-ended funds. The units of these funds can only be bought and sold during specified time intervals, similar to close-ended funds. Listing the units of interval schemes on stock exchanges is mandatory. Interval funds are suitable for investors who want exposure to unconventional assets, such as forestry tracts or commercial property.

II. Types Of Mutual Fund Schemes Based On Asset Classes

Equity Funds: Equity funds primarily invest in stocks and shares. As per regulations, they must invest at least 65% of their assets in equities or equity-related instruments, with the remaining invested in more stable asset classes to mitigate risk. The returns from these funds depend on the performance of the stocks they hold.

Equity funds can be further classified based on factors like management style (active vs passive), market capitalization of the stocks (small-cap, mid-cap, large-cap), geography (domestic, foreign, regional), and sector focus (e.g. pharma, FMCG, real estate). Equity funds are suitable for investors with long-term horizons, as they have historically provided superior returns compared to other mutual fund types, making them a robust option for wealth creation.

Debt Funds: Debt funds invest in fixed-income instruments like corporate/government bonds, T-bills, and CDs. They are less risky and have lower expense ratios than equity funds. Debt funds can offer better returns than traditional options like fixed deposits, making them a good choice for regular income.

Hybrid Funds: Hybrid funds have a mix of debt and equity components. They cater to investors with a moderate risk appetite. Hybrid funds can be categorized based on their asset allocation, such as (i) Conservative Fund (min. 75% debt), (ii) aggressive Fund (65-80% equity), (iii) Dynamic asset allocation Fund, (iv) Multi-asset allocation Fund, (v) Arbitrage Fund and (vi) Equity savings Funds.

Money Market Funds: Money market funds invest in low-risk, short-term securities like T-bills, CDs, and commercial paper. They offer high liquidity and are often used as short-term cash management tools.

III. Based On Portfolio Management

The classification of mutual funds based on portfolio management can be divided into two main categories:

Active Funds: In active funds, the fund managers actively manage the portfolio by making decisions on which securities to buy and sell. These funds are designed to outperform a specific benchmark index or achieve higher returns through active management strategies.

Passive Funds: Passive funds are designed to replicate the performance of a particular market index. Instead of trying to outperform the index, they aim to match the returns of the index they track. These funds are called 'passive' because they do not involve active stock selection or market timing strategies.

IV. Mutual Funds Are Classified Based On Their Investment Objective:

Growth Funds: These funds focus on investing in stocks of companies expected to have above-average growth rates compared to the overall market or their industry. They aim to provide high returns, but carry a higher level of risk.

Income Funds: These funds provide investors with a steady stream of income through interest payments or dividends. They typically invest in assets like bonds, dividend-paying stocks, and other fixed-income securities. These funds suit retirees or those seeking to supplement their current income.

Liquid Funds: These funds invest in short-term, highly liquid debt instruments with low risk. They are designed to provide a safe and liquid investment option, allowing easy conversion to cash without significant losses. Returns depend on prevailing short-term interest rates.

V. Mutual Funds Are Also Categorized Based On Risk Appetite:

Low-Risk Funds: These funds invest in lower-risk avenues like debt instruments, and are designed to provide stable returns rather than aggressive growth.

Medium-Risk Funds: These funds invest in a diversified portfolio of moderately risky assets, such as a mix of stocks, bonds, and other instruments. They aim to balance potential returns and risk exposure.

High-Risk Funds: These funds invest in high-risk assets like stocks, options, futures, commodities, or emerging markets. They aim to generate high returns and are suitable for wealth creation. Equity funds are an example of high-risk funds.

VI. Mutual Fund Scheme Types According To Specialization

The terms sector-specific or theme funds are also used to refer to specialty funds. They concentrate on particular economic areas, issues, or industries. These funds invest in businesses that operate in a specific industry or theme in an effort to take advantage of that industry's growth potential. Investors can choose from a variety of specialty funds in India. Here are some instances of thematic funds:

Sector funds: Sector funds are mutual funds that allocate their investments to a specific industry. The success of these industries determines the returns from these funds in full. Sector funds include, for example, real estate and technology funds.

Index funds: An index fund invests in a diverse portfolio of equities that, in the same proportion as the index, compose the selected index. Their passive investment approach aims to mimic the index they are tracking's performance.

Global funds: Also referred to as international funds, global funds let Indian investors make investments in foreign markets and securities. Having exposure to global markets aids in portfolio diversification for investors.

Fund of funds: Rather than making direct investments in specific securities or assets, fund of funds, also known as multi-manager funds, invest in a portfolio of other mutual funds. These funds seek to spread the risk of investments and maybe generate higher returns by participating in a number of different funds.

Retirement funds: Retirement mutual funds are created especially to help people save money for their later years. The combined funds are invested by these funds in bonds, stocks, and other securities.

Emerging market funds: The primary objective of these funds is to invest in assets issued by emerging market nations. These economies are usually characterized by rising industrialization, population expansion, and rapid economic growth. Putting money into emerging market funds permits investors to share in these nations' growing potential.

Certain mutual funds focus exclusively on debt investments, providing a guaranteed return on the capital invested. In contrast, others adopt a mixed approach, investing in both debt and equity to balance safety with reasonable returns. Additionally, these funds are increasingly investing in government securities, which offer the benefit of longer maturities and full security, unlike many other investment options that typically span three to five years, thus exposing investors to greater risk. Some mutual funds are open-ended, allowing for continuous investment, while others are closed-ended and terminate after a specified period. While some mutual funds concentrate on debt, others specialize in equity, and balanced funds incorporate both asset types. Research indicates that the reluctance to invest is often linked to the size of the city. Among individuals with high savings rates, nearly 40% of those residing in metropolitan and Tier I cities perceive such investments as highly risky, whereas 33% of respondents from Tier II cities express uncertainty about how or where to invest in these assets. In 2019, the mutual fund industry's assets under management increased by 13%, reaching 24 trillion by November 2018.

BENEFITS OF MUTUAL FUND

The following outlines the primary advantages of investing in mutual funds:

- Professional Management: Mutual funds offer the advantage of professional oversight, as experienced fund managers handle the investments. For investors who lack the time, interest, or expertise to manage their portfolios, mutual funds serve as a viable alternative. This option is cost-effective and particularly suitable for those making smaller investments.

- Economies of Scale: The inherent structure of mutual funds provides a significant advantage. By pooling funds from multiple investors, mutual funds benefit from economies of scale, resulting in lower costs compared to direct investments in capital markets, which often incur higher fees. This structure also enables retail investors to access high-entry markets, such as real estate, while maintaining better control over expenses.
- Diversification: Mutual funds allow investors to achieve diversification across various companies and sectors. In essence, diversification involves spreading investments across different assets, industries, and geographical regions to mitigate risks associated with downturns in specific areas. Since individual investors may lack sufficient capital to diversify effectively, mutual funds fulfill this need.
- Liquidity: Open-ended mutual funds offer high liquidity, enabling investors to buy or sell units at any time based on the current net asset value (NAV). Closed-end funds are traded on stock exchanges, allowing investors to redeem their units at market prices. Additionally, interval funds, which combine features of both open and closed-end structures, provide periodic liquidity options for investors.
- Flexibility: Regular mutual fund schemes offer numerous features that enhance their flexibility. Investors have the option to choose from various plans such as Systematic Investment Plans (SIP), Systematic Withdrawal Plans (SWP), and Systematic Transfer Plans (STP) to manage their cash flow according to their preferences. Additionally, the diverse range of schemes introduced by different mutual funds in India allows investors to tailor their portfolios to meet their specific needs.
- Convenience: Mutual fund companies provide accessible methods for investing in their schemes. Investors can utilize online platforms or mobile applications, alongside the traditional method of completing and submitting a physical application form. Moreover, since bank details are required during the investment process, redemptions are streamlined, allowing investors to receive their proceeds directly into their bank accounts.
- Transparency: The mutual fund sector in India operates with a high level of transparency, offering a wealth of information to investors through various resources such as fact sheets, offer documents, and annual reports.
- Well Regulated**:** The Indian mutual fund industry is governed by the Securities and Exchange Board of India (SEBI), which fosters investor confidence and provides reassurance. The regulatory framework in India is robust, ensuring transparency in all processes and transactions.

The management of debt within mutual funds is inherently more secure, particularly when compared to the potential volatility associated with equity-related funds. Recently, numerous mutual funds have started to include Gilt investments in their portfolios. Mutual funds offer several unique advantages over alternative investment options. They are generally considered safe and have the potential to generate higher returns. When stock markets perform well, mutual funds are also likely to deliver improved returns. Additionally, these funds are overseen by professionals whose investment strategies typically surpass those made by individual investors. The performance metrics of mutual funds are regularly published in newspapers, allowing individuals to make informed decisions regarding the buying or selling of fund units. The Net Asset Value (NAV) of each mutual fund is updated weekly, along with their respective purchase and sale prices, which aids investors in making sound investment choices.

The recent Information Technology (IT) advancements in the country have further enhanced the appeal of mutual funds. Online trading options for mutual funds are now available, and most funds can be accessed through a Demat account. This development empowers investors to determine the most advantageous timing for selling their mutual fund holdings. Moreover, the Demat facility not only simplifies the selling process but also assists buyers in making optimal reinvestment decisions.

RECENT TRENDS IN MUTUAL FUNDS IN INDIA

The IT-enabled services provided by Demand have significantly contributed to the rapid growth of Mutual Funds (MFs). Over the past decade, MFs have become a vital component of the Indian economy, emerging as a robust investment option for small and individual investors interested in equities. Notably, MFs have served as an effective mechanism for directing individual savings into the stock market. For instance, by January 2001, the total sales of all MFs in India for that year reached Rs. 10,324 crore, while redemptions amounted to Rs. 8,099 crore. Consequently, the net sales of MF stocks were recorded at Rs. 2,225 crore in January 2001, compared to net sales of Rs. 3,508 crore in January 2000. This net sales figure indicates the additional investments made in the industry, primarily from small and individual investors, alongside contributions from various business entities, groups, banks, and financial institutions that operate their own MFs. These funds not only manage investments for individual clients but also allocate resources to the stocks of their affiliated companies, including new offerings. For example, if a new issue from an industrial group is under-subscribed, the associated fund may invest in that issue to bolster its success. Thus, MFs also serve as an immediate source of financing for urgent projects within these business houses. Currently, the Mutual Fund market is estimated to be around Rs. 1,00,000 crore. In the fiscal year 1999-2000, net inflows into MFs ranged from Rs. 1,200 to 1,500 crore. This period also saw a shift in investor sentiment away from equity funds. Notably, two MFs, Birla and Prudential, rose to prominence, competing with major public sector funds such as UTI and SBI Mutual Fund. The growth of this sector within the capital market, particularly the steady rise of private sector MFs, bodes well for the economy. In the coming years, MFs are anticipated to play a crucial role in the country's economic landscape, especially with the recent tax exemption on income generated from MFs.

The Union Budget for the fiscal year 2000-2001 significantly impacted mutual funds (MFs) when the effective tax rate on dividends distributed by debt-oriented funds was increased from 11% to 22%. In contrast, dividends from equity schemes remained tax-exempt. Consequently, this led to a detrimental effect on debt-oriented funds, prompting a notable shift of investments from these schemes to equity-oriented alternatives. Recognizing this error, the subsequent Union Budget for 2001-2002 reduced the tax on dividends from domestic companies and MFs to a more favorable rate of 10%. This adjustment is expected to invigorate the capital market overall, with particular benefits for MFs. Additionally, the Finance Minister announced an exemption on long-term capital gains from the sale of securities and units, provided these gains are reinvested in primary share offerings of public companies. The reduction of interest rates to 9.5% for provident funds and small savings schemes in the 2001-2002 Union Budget is anticipated to lower the general interest rates within the economy.

The Reserve Bank of India (RBI) has already decreased the Bank Rate to 7%, and a significant reduction in the prime lending rate by banks is expected. This alignment of interest rates with global standards is likely to reduce the cost of capital, thereby stimulating investment in the industrial sector. As a result, mutual funds are expected to capture a larger share of the savings from the general populace. Consequently, the significance and role of these funds are poised to expand considerably in the near future. The capital market is likely to see the emergence of numerous new MFs, which will bear greater responsibility in protecting the financial interests of investors who will increasingly trust them for prudent investment and enhanced returns. The Indian economy demonstrates resilience and vibrancy, having successfully navigated the Asian financial crisis of 1997 and the subsequent global recession.

In spite of various challenges, the Indian economy has achieved a remarkable growth rate exceeding 6 percent over the years. The Finance Minister is optimistic that a growth rate of 6.5 percent is attainable in the current financial year, even amidst a global economic slowdown. The government has set an ambitious target of reaching approximately 8 percent growth within the next three years. To realize and maintain such elevated growth rates, increased capital investment is crucial.

CONCLUSION

The decision to lower interest rates on provident funds and small savings represents a strategic move to redirect public savings from traditional channels into stocks and industrial debt, thereby elevating investment levels beyond conventional standards. Consequently, Mutual Funds are poised to play a vital role in boosting capital investment in the industrial sector while meeting the expectations of small and individual investors who rely on them. In an increasingly globalized economy, enhancing domestic capital investment rates is essential, a task that Mutual Funds are effectively addressing.

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