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An Insight into Mutual Funds Investments & Fiasco in India

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ABSTRACT

A mutual fund is a pool of money managed by a professional Fund Manager. It is a trust that collects money from a number of investors who share a common investment objective and invests the same in equities, bonds, money market instruments and/or other securities. And the income / gains generated from this collective investment is distributed proportionately amongst the investors after deducting applicable expenses and levies, by calculating a scheme's "Net Asset Value" or NAV. Simply put, the money pooled in by a large number of investors is what makes up a Mutual Fund.

KEYWORDS: Mutual Fund, NAV, Fund Manager

INTRODUTION

Modern portfolio theory suggests a diversified portfolio of shares and other asset classes (such as debt in corporate bonds, treasury bonds, or money market funds) will realize more predictable returns if there is prudent market regulation. The first introduction of a mutual fund in India occurred in 1963, when the Government of India launched the Unit Trust of India (UTI).[1] Mutual funds are broadly categorized into three segments: equity funds, hybrid funds, and debt funds.

Mutual funds are ideal for investors who either lack large sums for investment, or for those who neither have the inclination nor the time to research the market, yet want to grow their wealth. The money collected in mutual funds is invested by professional fund managers in line with the scheme's stated objective. In return, the fund house charges a small fee which is deducted from the investment. The fees charged by mutual funds are regulated and are subject to certain limits specified by the Securities and Exchange Board of India (SEBI).[2]

India has one of the highest savings rate globally. This penchant for wealth creation makes it necessary for Indian investors to look beyond the traditionally favored bank FDs and gold towards mutual funds. However, lack of awareness has made mutual funds a less preferred investment avenue.

Mutual funds offer an excellent avenue for retail investors to participate and benefit from the uptrend's in capital markets. While investing in mutual funds can be beneficial, selecting the right fund can be challenging. Hence, investors should do proper due diligence of the fund and take into consideration the risk-return trade-off and time horizon or consult a professional investment adviser. Further, in order to reap maximum benefit from mutual fund investments, it is important for investors to diversify across different categories of funds such as equity, debt and gold.

TYPE OF MUTUAL FUND SCHEMES

Mutual Fund schemes could be 'open ended' or close-ended' and actively managed or passively managed.

OPEN-ENDED AND CLOSED-END FUNDS

An open-end fund is a mutual fund scheme that is available for subscription and redemption on every business throughout the year, (akin to a savings bank account, wherein one may deposit and withdraw money every day). An open ended scheme is perpetual and does not have any maturity date.

A closed-end fund is open for subscription only during the initial offer period and has a specified tenor and fixed maturity date (akin to a fixed term deposit). Units of Closed-end funds can be redeemed only on maturity (i.e., pre-mature redemption is not permitted). Hence, the Units of a closed-end fund are compulsorily listed on a stock exchange after the new fund offer, and are traded on the stock exchange just like other stocks, so that investors seeking to exit the scheme before maturity may sell their Units on the exchange.

ACTIVELY MANAGED AND PASSIVELY MANAGED FUNDS

An actively managed fund is a mutual fund scheme in which the fund manager "actively" manages the portfolio and continuously monitors the fund's portfolio , deciding on which stocks to buy/sell/hold and when, using his/her professional judgments, backed by analytical research. In an active fund, the fund manager's aim is to generate maximum returns and out-perform the scheme's bench mark.

A passively managed fund, by contrast, simply follows a market index, i.e., in a passive fund , the fund manager remains inactive or passive inasmuch as, he/she does not use his/her judgment or discretion to decide as to which stocks to buy/sell/hold , but simply replicates / tracks the scheme's benchmark index in exactly the same proportion. Examples of Index funds are an Index Fund and all Exchange Traded Funds. In a passive fund, the fund manager's task is to simply replicate the scheme's benchmark index i.e., generate the same returns as the index, and not to out-perform the scheme's bench mark.

MUTUAL FUNDS STATISTICS

The total Assets Under Management (AUM) of the Indian mutual fund industry as of December 31, 2024, stood at a staggering Rs.50.78 trillion (US$600 billion). This is a significant milestone, marking over a six-fold increase compared to the Rs.8.26 trillion (US$98 billion) recorded in December 2013.[3] According to SEBI, during FY 2022–23, 73% of mutual fund units were redeemed within 2 years of investment. Only investments in 3% of the units continued for more than 5 years.[4]

According to the Reserve Bank of India report, mutual funds attracted 6% of household savings in FY2023 and less than 1% went into direct equities.[5] Almost 95% of household savings in India park their money in bank deposits, including fixed deposit, provident fund, PPF, life insurance, and various small savings schemes.[6]

According to the S&P SPIVA Report FY2022, over a 10-year period, approximate 68% of the large-cap actively managed funds failed to beat their respective benchmarks, and over 50% failed to beat their benchmarks in the mid- and small-cap segments.[7] Within the ELSS funds category, over 60% failed to beat their respective benchmarks over 10 year period. Globally, over long periods of time, passively managed funds consistently outperform actively managed funds.[7]

MUTUAL FUNDS REDEEMED DATA

Holding Period	Units redeemed in FY23	Units redeemed in FY24
0 – 1 years	56.83%	50.11%
1 – 2 years	15.14%	23.04%
2 – 3 years	5.03%	9.81%
3 – 5 years	20.41%	13.96%
More than 5 years	2.59%	3.09%

Mutual fund category breakup: (Assets under Management (AUM))

- AUM of Equity funds – Rs.20.33 lakh crore (US$240 billion) (November 2023)
- AUM of Hybrid funds – Rs.6.90 lakh crore (US$82 billion) (January 2024)
- AUM of Debt funds – Rs.11.97 trillion (US$140 billion) (March 2020)

MAJOR MUTUAL FUNDS FIASCOS

1. Franklin Templeton Mutual Fund fiasco

In April 2020, Franklin Templeton India unexpectedly wound up six credit funds with assets of close to $4 billion, citing a lack of liquidity amid the corona virus pandemic. These funds had large exposure to higher-yielding, lower-rated credit securities. The Securities and Exchange Board of India (SEBI) conducted a probe into this sudden closure and found “serious lapses and violations”. As a result, in June 2021, SEBI barred Franklin Templeton Mutual Fund from launching any new debt schemes for two years. The regulator also ordered the fund house to refund investment and advisory fees, along with interest, of more than 5 billion rupees, and fined the global giant another 50 million rupees.

Franklin Templeton said it strongly disagreed with the SEBI’s order and planned to appeal against it. The decision to wind up the schemes “was taken with the sole objective of preserving value for unit holders”, a spokesperson said. However, the closure of these funds sparked panic withdrawals from other Franklin Templeton schemes as well as credit funds of other asset managers, leading to a storm on social media and court cases by distraught investors.

2. Reliance Mutual Fund

In 2019, the debt schemes of Reliance Mutual Fund faced a liquidity crisis due to their exposure to troubled companies like Dewan Housing Finance Corporation (DHFL). This led to severe redemptions and forced asset sales, which significantly affected investors.

3. IL&FS crisis and impact

The IL&FS crisis in 2018 had a significant impact on the mutual fund industry, including those managed by IDBI Mutual Fund. The defaults by IL&FS led to a series of downgrades and defaults on its debt obligations and inter-corporate deposits1. This situation caused considerable distress in the financial markets and led to significant markdowns in the Net Asset Values (NAVs) of the affected mutual fund schemes, resulting in losses to investors.

The defaults by Infrastructure Leasing & Financial Services (IL&FS) triggered a liquidity crisis, making it difficult for mutual funds to meet redemption demands without selling assets at distressed prices. This event heightened concerns about credit risk, leading to widespread downgrades of IL&FS and other non-banking financial companies (NBFCs). Consequently, the net asset values (NAVs) of mutual funds holding these securities were adversely affected, reflecting the increased credit risk and decreased market confidence.

Investor confidence in debt mutual funds, particularly those with high exposure to NBFCs and infrastructure debt, was severely undermined. This led to significant outflows as investors moved towards safer and more liquid investment options. In response, the Securities and Exchange Board of India (SEBI) introduced stricter regulations on sectoral exposure, single issuer limits, and the quality of collateral accepted in debt funds to enhance liquidity and reduce risks. Fund managers began focusing on higher-quality assets and improved risk management practices. The crisis underscored the need for better credit assessment and liquidity management, prompting regulatory reforms and a more cautious investment approach within the mutual fund industry.

4. Amtek Auto Impact

Several mutual funds, including those managed by JP Morgan Asset Management India, faced significant issues due to exposure to Amtek Auto, which defaulted on its debt in 2015. JP Morgan had to suspend redemptions and impose exit loads to manage the liquidity crisis.[28][29][30]

5. Birla Sun Life Mutual Fund (Aditya Birla Sun Life Mutual Fund)

In 2018, Aditya Birla Sun Life Mutual Fund faced redemption pressures in some of its debt schemes due to exposure to entities like the Essel Group companies. The Economic Times reported that the Aditya Birla Sun Life Mutual Fund was the biggest investor in the Essel Group, with an exposure of Rs 2,936 crore spread across 28 schemes1. This accounted for almost 37% of the total debt fund exposure to the Zee group, which is part of the Essel Group.

6. Dewan Housing Finance Corporation (DHFL) crisis and impact

The Dewan Housing Finance Corporation (DHFL) crisis had a profound impact on the Indian mutual fund industry. DHFL's defaults created a severe liquidity crunch, making it difficult for mutual funds to meet redemption pressures without selling assets at heavily discounted prices. This crisis raised significant concerns about the creditworthiness of housing finance companies (HFCs) and non-banking financial companies (NBFCs), leading to downgrades of DHFL's debt instruments and adversely affecting the net asset values (NAVs) of mutual funds holding these securities.

Investor confidence in debt mutual funds, especially those with high exposure to HFCs and NBFCs, was severely shaken, resulting in substantial outflows as investors sought safer investments. In response, the Securities and Exchange Board of India (SEBI) increased scrutiny and introduced tighter regulations on mutual funds' exposure to individual issuers and sectors to mitigate such risks in the future. Fund managers adjusted their portfolios by shifting towards higher-quality and more liquid assets, reducing exposure to high-risk debt instruments. The crisis underscored the importance of credit quality and liquidity management, prompting regulatory reforms and a more cautious approach within the mutual fund industry.

7. UTI Mutual Fund (Unit Trust of India) fiasco

The Unit Trust of India (UTI) faced a significant crisis in 2001, which was primarily due to large-scale redemption pressures and mismanagement, particularly in its flagship scheme, US-6412. The crisis was exacerbated by the Ketan Parekh scam, which caused a sharp decline in stock prices, leading to mutual funds, including UTI's schemes, suffering severe consequences.

The government intervened to protect investors and restructured UTI. This restructuring led to the bifurcation of UTI into two separate entities in 2003: the UTI Mutual Fund (now managed by the UTI Trustee Company Pvt. Ltd.) and the Specified Undertaking of the Unit Trust of India (SUUTI), which took over the assets and liabilities of the erstwhile UTI12. The government's intervention included a bailout package to stabilize the situation and ensure the protection of investors' interests.

8. DHFL Pramerica Mutual Fund

Dewan Housing Finance Corporation Limited (DHFL) defaulted on its debt obligations in 2019. This event led to significant governance concerns and defaults by DHFL in meeting various payment obligations, prompting the Reserve Bank of India to supersede the Board of Directors of DHFL1. The default affected several mutual funds, including those managed by BNP Paribas Asset Management India Private Limited, which had to mark down the value of their investments in DHFL's securities.

The crisis deepened with rating downgrades and write-offs by mutual funds, which had a cumulative exposure of Rs.5,336 crore to securities issued by DHFL3. As a result, there was a severe liquidity issue and a drop in the Net Asset Values (NAVs) of the mutual funds, impacting investors' returns. DHFL Pramerica Mutual Fund, which was a joint venture between DHFL and Pramerica Financial, Inc., also faced challenges due to the exposure to DHFL's debt instruments.

9. Yes Mutual Fund

In 2019, Yes Bank faced severe financial stress and was eventually placed under a moratorium by the Reserve Bank of India (RBI) in March 2020. This led to significant challenges for Yes Mutual Fund, particularly its debt schemes that had exposure to Yes Bank's securities. The crisis necessitated write-downs and affected investor confidence. Around 32 mutual fund schemes had exposure to Yes Bank's downgraded debt papers, with a total exposure amounting to approximately Rs.2,848 crore. The crisis led to write-downs of these securities and impacted the net asset values (NAVs) of the mutual funds involved, which in turn affected investor confidence.

10. Kotak Mutual Fund

In 2019, Kotak Mutual Fund did face challenges with its Fixed Maturity Plans (FMPs) due to exposure to debt securities of companies like the Essel Group. The fund house was unable to redeem investments from these companies, which led to delays and partial rollovers of the FMPs. This situation affected the investors' expected returns. Consequently, the Securities and Exchange Board of India (SEBI) barred Kotak from launching new FMPs for six months and imposed a fine for failing to abide by regulatory requirements.

11. HDFC Mutual Fund

HDFC Mutual Fund did face a situation in 2018-2019 due to its exposure to companies like Essel Group and IL&FS. The credit events involving these companies led to significant mark-downs in the Net Asset Values (NAVs) of some of HDFC Mutual Fund's debt schemes. This situation resulted in investor concerns and redemption pressures.

To elaborate, the IL&FS crisis was one of the biggest financial crises in India, with the company defaulting on several of its obligations due to a cash shortfall. The debt involved was about Rs 1 lakh crore. Similarly, Essel Group companies were grappling with debt woes, which put mutual funds, including HDFC, under redemption pressure. However, HDFC Mutual Fund later recovered the entire investment made in the non-convertible debentures issued by Essel Group companies.

12. Sahara Mutual Fund

SEBI conducted an examination to determine whether Sahara Mutual Fund, its Asset Management Company, and its trustees were 'fit and proper' as per regulatory standards. This was in light of a previous SEBI order from 2011 concerning two other Sahara entities, which were directed to refund money collected through Optionally Fully Convertible Debentures (OFCDs) to investors.

In 2015, SEBI ordered the winding up of Sahara Mutual Fund's schemes due to non-compliance with regulatory requirements. The regulatory scrutiny and legal challenges indeed led to operational difficulties and affected investor confidence in the fund house.

CONCLUSION

The capital market regulator SEBI is now considering more action to protect the small investor by segregating corporate and retail investors. However, the suggestion is unlikely to gain any ground. The fund houses will have to float funds that cater to different investor classes, defeating the concept of pooled investment that mutual funds work on. One way to increase retail penetration is for the funds to penetrate smaller cities and towns. A few funds like the Reliance Mutual Fund and SBI Mutual Fund have been making headway in tier II and tier III cities. But most fund houses believe that this is not worth the effort. After all, they can spend that time and money in getting big bucks from corporate.
In other, developed markets, mutual funds are seen as ideal vehicles for retail investors. There, investing directly in the stock market is considered a risky game that only the big players can afford to play. Here, however, it appears that all instruments are skewed in favor of the large corporate investors.

The study of problems of mutual funds reveals that investor low level of awareness and rising costs are the mainstream problems of industry. Due to this, retail participation has been quite low. The industry has yet to tap potential customers in small cities and rural areas. Compared to US, UK and Japan, the Indian mutual funds industry is incredibly slow in innovative product offering. The mis selling by distributors that basically put a matter mark on the competence, value and degree of commitment of fund distributors to investors. In our review of offer documents of selected investment firm schemes viz., Birla Sun Life, LIC Nomura, UTI and Sahara found ambiguous description of risk factors and risk controlling procedures, absence of portfolio turnover rates and use of tough and vague language. On regulatory front, the industry, in spite of getting a comprehensive set of regulations, still has some problematic areas. A number of these are inadequate fund governance provisions, small penal provisions for officers and key personnel, absence of qualification for fund managers and trustees, lack of proper regulations for distributors, low flexibility in funds investment objectives and confusing products names and definitions. Other problems of mutual funds include the rising investors' complaints, malpractices in trading, low financial literacy, single lingual mechanism, secrecy in documents and herding behavior of investors. The mutual funds industry in India has evolved in many aspects, be it the entire assets accretion, products offered, number of investor accounts, players or the amount of technological up gradation. The industry is anticipated to grow rapidly due to favorable economic & financial scenario, conducive regulatory environment and due the very fact that Indian class has shown enormous interest in recent years. The rising saving rate and dealing age population in the country may further accelerate investment in mutual funds in coming years.

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