Myopic investment view of the Indian mutual fund industry

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Abstract

This paper examines the investment behavior of Indian mutual fund industry. Since the majority of investors who invest in mutual funds are salaried individuals or individuals that own SMEs, the Indian Mutual Fund industry should have a long term investment horizon. However, the data from all mutual funds for the periods December 2007 to May 2008 and December 2008 to May 2009 reveals that the mutual fund industry has adjusted its position on a short term basis in tandem with the short term volatility of the market. The findings substantiate the SEBI Chairman's observation that there is an urgent need to set up investment norms with regard to the holding period for stocks owned by the Indian mutual fund industry.

1. Introduction

The Indian financial market is one of the fastest emerging markets in Asia and has attracted a lot of attention from professionals and researchers. Whilst the focus for professionals has been the impressive growth and the vast potential that the market seems to offer, researchers, on the other hand, are trying to focus on interpreting the so-called spectacular success and understanding the various factors at play. The one area that has been of particular interest is the strength of the short term return in the Mutual Fund industry. Sehgal and Jhanwar(2008) makes an attempt at quantifying the reasons for the short term returns by examining the three aspects: (a) Investment "churn" of the industry, (b) Sector exposure movements, and (c)Investment movement patterns for two periods of six months each. The paper is based on the hypothesis that in consideration of the investor profile of the Mutual Fund industry, the funds are required to take a long term perspective of the investments that they indulge in.

Trends in the Mutual Fund Industry

The mutual fund industry in India has its origins in the Parliament Act 52 of 1963. The Act proposed setting up of an asset management company (AMC) in order to create an instrument for channeling investments. The Unit Trust of India (UTI) was incorporated in February 1964 and the first fund was called Unit Scheme 1964, popularly known as US 64.

The first phase of expansion of the industry was witnessed in the year 1987 with the advent of public companies that entered the market. Two banks and two insurance companies joined the fray, thus bringing to an end the monopoly that UTI enjoyed in the market.

Industry	**Name**	**Year**
Banking	State Bank of India	1987
	Canara Bank	1987
Insurance	LIC	1989
	GIC	1990

In 1992 India saw the Securities and Exchange Board of India (SEBI) Act approved by the parliament. This Act was designed to maximize protection for investors' interests and regulate the financial markets.

The following year witnessed a turning point in the Indian Mutual Fund industry with SEBI permitting entry of private AMCs into the mutual fund market. The entry of private sector offered investors a wider range of options and increased the level of competition among funds, thus resulting in exponential growth of the Mutual Fund industry. Moreover, a number of mergers and acquisitions also contributed to the changing scenario of the industry. Apparently, the Mutual Fund industry in India was passing through a new stage of growth and consolidation towards a liberalization phase.

Thus, by 1993 the Mutual Fund industry emerged with nine AMCs managing funds worth approximately Rs 47,004 crores, an equivalent of around Rs 470,000 mn, almost USD 15,000 mn.

By the beginning of 2003 India had 33 AMCs that controlled funds worth approximately Rs 121,805 crores (slightly over USD 25,000 mn). The latest position as on June 30, 2009 shows the existence of 35 AMCs managing 3893 schemes and controlling funds worth approximately Rs 670,936 crores (around USD 150,000 mn).

There are a number of Mutual Fund Schemes operating in India catering to the various demands of the investors in terms of their:

- financial requirements
- risk tolerance
- expectation of returns

Mutual funds are classified on the basis of their structure, nature and objectives.The following table presents classification of Mutual Funds:

Overview of Existing Schemes

Structure	Nature	Investment objective
Open-Ended Schemes:	Equity funds: • Diversified Equity Funds • Mid-Cap Funds • Sector Specific Funds • Tax Savings Funds (ELSS)	Growth Schemes
Close-Ended Schemes:	Debt funds • Gilt Funds • Income Funds • MIPs • Short Term Plans (STPs) • Liquid Funds (Money Market Schemes)	Income Schemes
Interval Schemes	Balanced funds	Balanced Schemes
		Money Market Schemes
		Other Schemes • Tax Saving Schemes: • Index Schemes: • Sector Specific Schemes

Investor Profile of the Mutual Fund Industry

Sadhak(1998) quotes that "The SEBI-NCAER survey's findings regarding the occupational background of mutual fund investors indicate that nearly 14 million or 93% of the unit-owning households fall in the category of salaried or self-employed or wage owners' class. In the salaried class, 42% unit-owning households are retired".

Another study conducted by H Sadhak quoted in the above reference indicated that while 32.43% investors belonged to the service class, 24.57% belonged to the business or the professional class. The same study also recorded that of the 7 lakh investors surveyed, more than 57% preferred monthly income schemes, 35% invested in tax-saving schemes and 8% in income and growth schemes. In terms of funds, 72% was invested in monthly income schemes, 24% in tax-saving schemes and only 4% in income and growth schemes.

The above findings indicate that majority of the mutual fund investors are wage earners who invest a part of their savings in the Mutual Fund schemes with a view to get a comfortable return with a long term investment perspective.

2. Brief Review of Related Literature

Although the Mutual Fund industry has been the subject of a number of studies that have drawn various conclusions, the literature on the Indian Mutual Fund industry continues to be woefully inadequate.

Hitherto the approach to the study of the Mutual Fund industry has been mostly from the perspective of relating the returns with the type of investment. Menkoff and Schmidt (2005) concludes that apparently implementation of all of these strategies, as supported by questionnaire evidence, might be difficult to reconcile with efficient markets.

Sehgal and Jhanwar(2008) concludes that short-term persistence in equity mutual funds performance does not necessarily imply superior stock selection skills. The paper has done some detailed factor analysis for the short term returns model, elaborating on the causes of the short term returns and attributing the root cause to the myopic view of the Mutual Fund industry.

Agudo and **LÃ¡zaro** (2005) infers that risk is one of the variables that influences the evolution of Indian mutual fund NAVs. Classifying funds in terms of risk produces small deviations with regard to the criteria of percentages in investment that allow the classification made by the institutions responsible for ensuring correct functioning and investor security in the mutual fund market. We can find one explanation in the fact that this market is not sufficiently developed to be able to sustain an institution that can efficiently control the investments made by different mutual funds. Alternatively, the predetermined criteria are simply not followed.

3. Data

The data was taken from the ICRA database using the MFI explorer software. The researchers studied the data from all mutual funds for the periods December 2007 to May 2008 and December 2008 to May 2009. The two periods were chosen on the basis of the fact that December 2008 to May 2009 had witnessed tremendous volatility in the market. Data was aggregated in entirety for each of the fund houses and the various schemes were clubbed. The research was confined to data pertaining to the equity market exposure only. The quantitative data for equity in foreign investments by mutual funds was not reported by MFI explorer of ICRA.

4. Research Findings

A. Trends in Top Five Funds

The objective of the study was to obtain a general overview of the investment pattern of the Indian mutual funds. In order to achieve this it was necessary to observe the investment trends over a period of time that was long enough to facilitate meaningful comparison and short enough to catch the short term investment pattern. Thus it was decided to compare the trends in operations for all Mutual Fund companies in India for the periods December 2007 to May 2008 and December 2008 to May 2009. It became necessary to focus on the net movement of funds in order to assess the general trend in movement of funds. Thus the net of sales and purchases was calculated for each month for all funds in terms of quantity (number of shares bought and sold) and value (net change in value of equity investment).

The following table presents the data for the top five mutual funds chosen on the basis of the value of the Assets under Management (AUM) for the period of December 2008 to May 2009.

Top Five Funds:

Trends in Net Quantity of Equity Sold & Purchased
December 2008 to May 2009

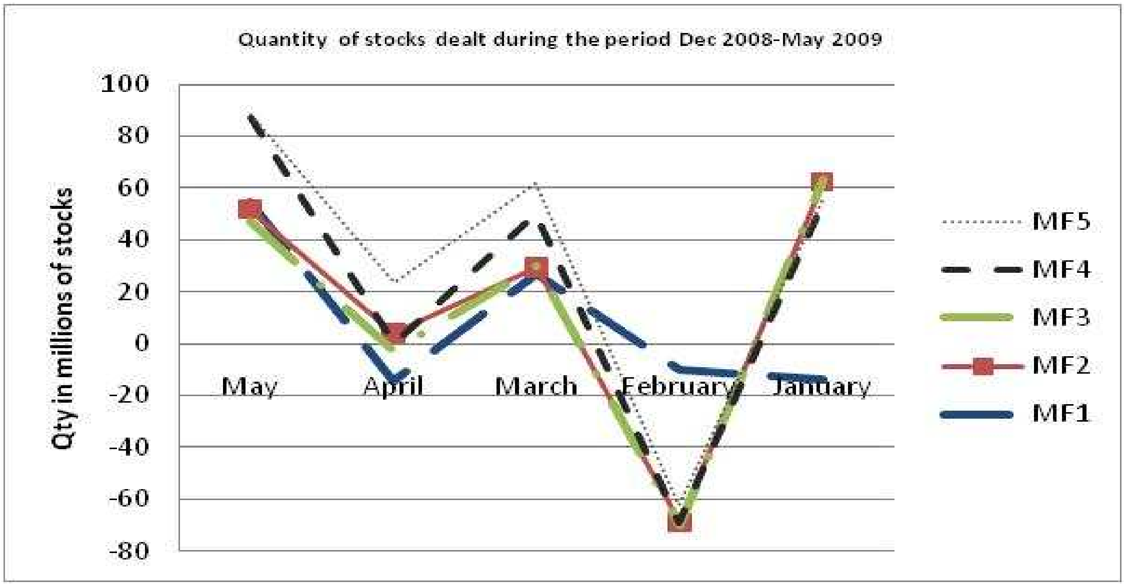
(Quanity in millions of shares)

Fund Rank	May 09	April 09	March 09	February 09	January 09
1	54.612	(14.450)	26.827	(9.954)	(13.929)
2	(2.728)	18.390	2.378	(59.058)	76.272
3	(4.376)	(6.478)	0.511	(0.954)	0.735
4	39.317	2.322	20.554	1.046	(9.253)
5	1.605	23.820	11.310	6.635	1.258

Source: ICRA Data

The numbers in the table are the net securities purchased by the funds during the respective months. Positive numbers indicate the net additions to the number of shares during the period while negative numbers imply net sales, viz. securities sold exceeding those bought during the said period.

The following chart presents comparative positions of the top five funds for the period December 2008 to May 2009.



A clear trend emerging from the above chart shows that the top five funds follow a very similar pattern with heavy downloads in the months of February and April 2009, and heavy buying in the months of March and May 2009. The first and second ranked mutual funds also show some extreme positions during the six month period.

The following table and the subsequent chart will facilitate comparison of the above trends with those in the earlier year. The ranking of the funds is based on the ranking of the assets under management as on May 31, 2009.

Top Five Companies: Trends in Quantity
December 2007 to May 2008

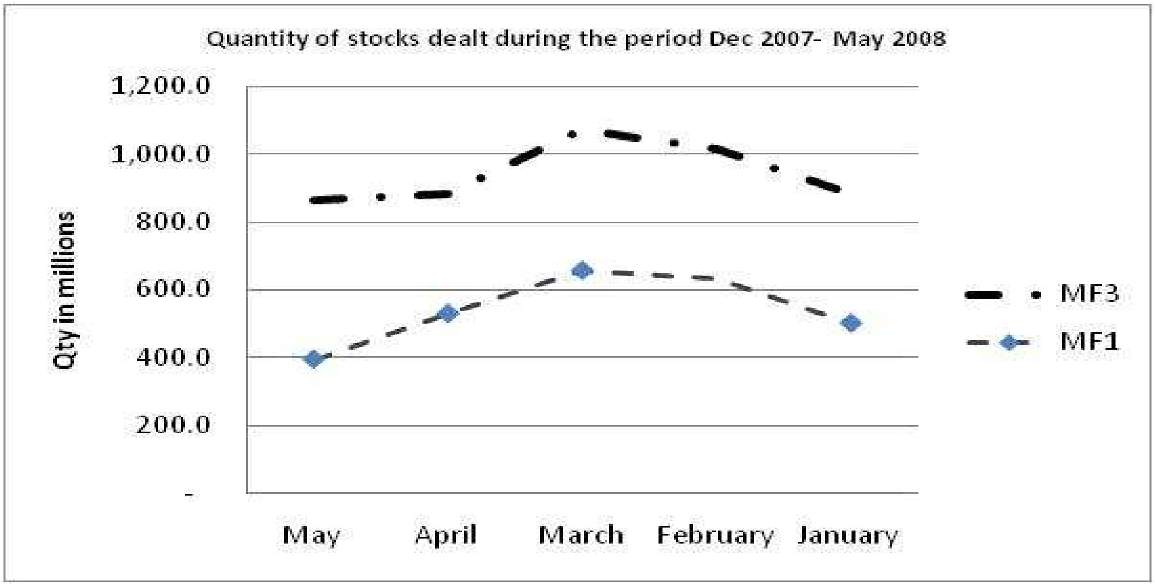
(Quanity in millions of shares)

Fund Rank	May 08	April 08	March 08	February 08	January 08
1	394.2	530.6	658.8	635.1	501.7
2	(16.6)	6.1	24.3	(7.4)	35.0
3	470.1	355.4	412.7	379.9	379.9
4	7.2	(3.7)	(16.9)	38.4	15.0
5	1.7	(50.9)	(2.8)	10.2	(1.7)

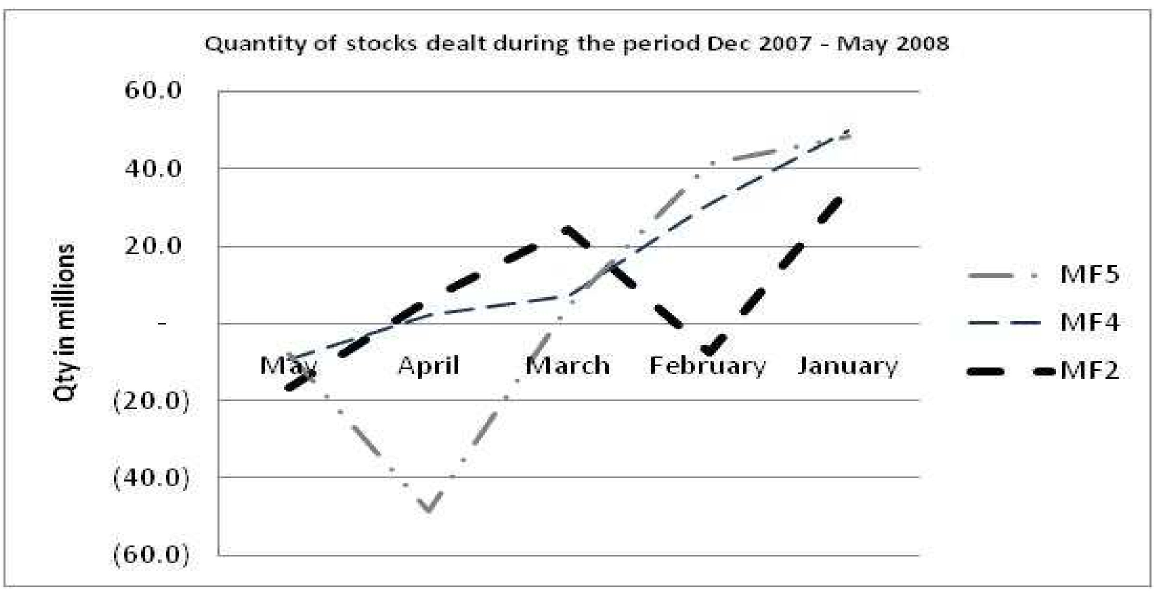
Source: ICRA Data

The above table shows that the funds having ranks one and three apparently have tremendous volume being traded while the other three funds seem to lag far behind. The numbers have been represented in two charts as follows:

MF1 and MF3



MF5, MF4 and MF2



The following table presents the data for the top five **mutual** funds for the period of December 2008 to May 2009 in value terms:

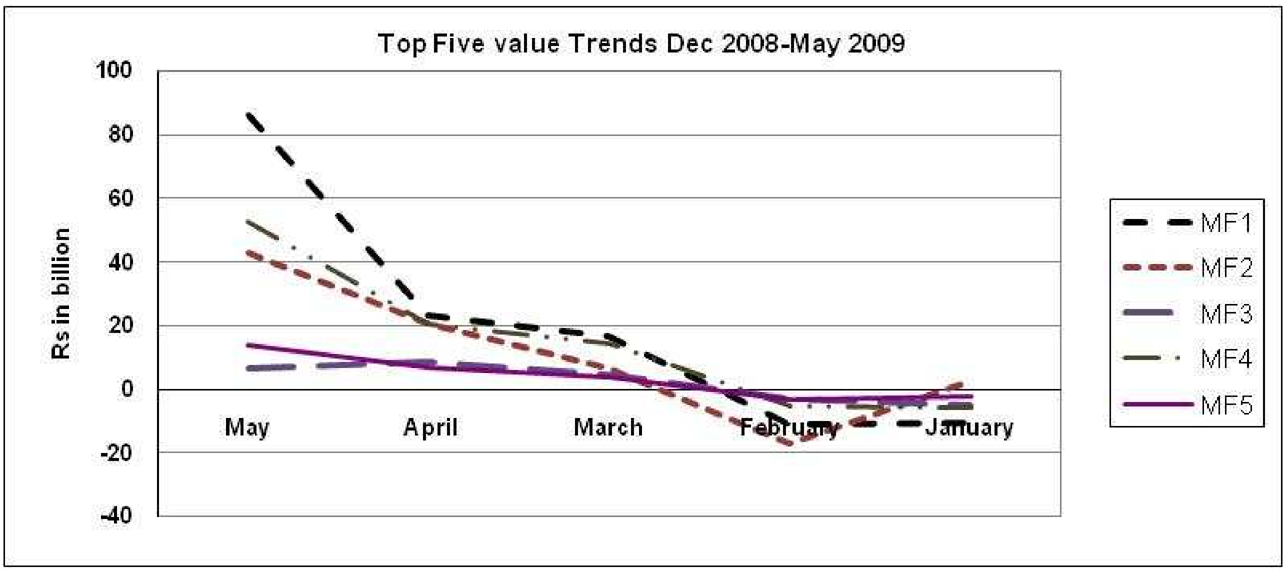
Top Five Companies: Trends in Value
December 2008 to May 2009

(Amounts in Rs billion)

	May	April	March	February	January
MF1	86.1	23.2	16.9	-10.9	-10.4
MF2	42.8	20.4	6.8	-16.9	2.5
MF3	6.4	8.6	4.8	-2.8	-4.9
MF4	52.6	20.5	14.5	-5.1	-5.9
MF5	14.0	7.1	3.7	-3.2	-2.2

All numbers in the table are approximated to the nearest billion rupees. Positive numbers imply net addition to the value while negative numbers imply net fall in the value of holding.

The following chart offers a comparative view.



The trend in the value of holdings is more comparable vis-a-vis that in quantity. While funds have moved in tandem in taking new positions of purchase and sale for the months, one observes extreme positions on some occasions. Mutual funds 2 and 4 show heavy trading in the months of February, March, April and May, while Mutual Fund 1 shows strong variations in the value of holdings in all five months.

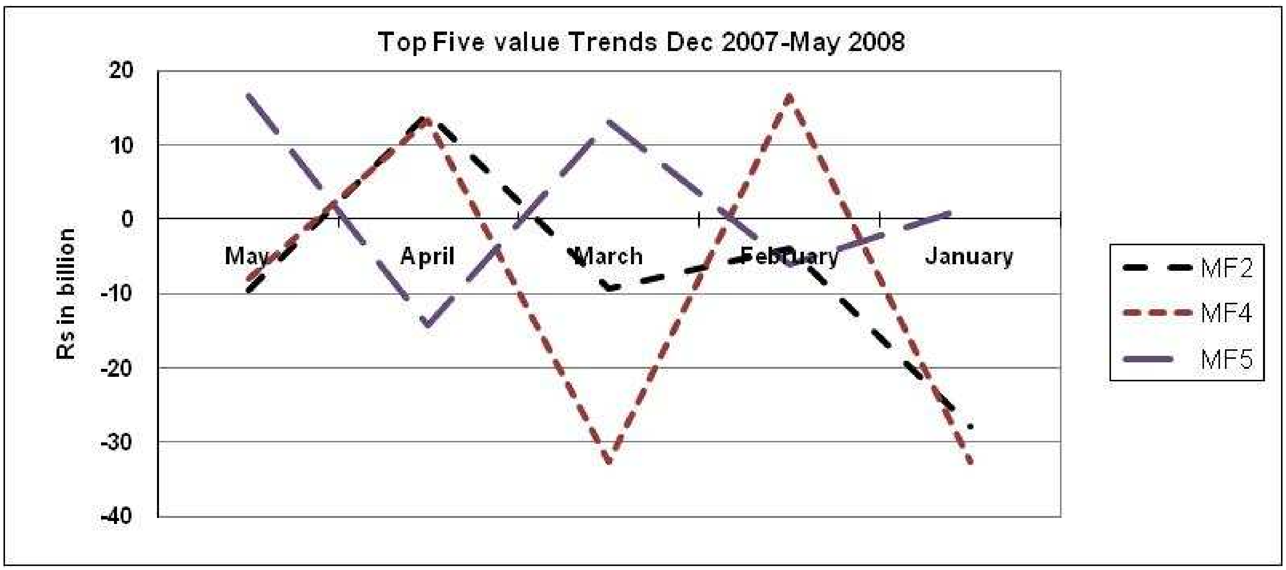
The change in value terms represents a composite effect of changes due to buying and selling by the funds and the market volatility in terms on prices of securities. For the given period of time the market volatility as indicated by BSE SENSEX was on an average 25% on an annualised basis.

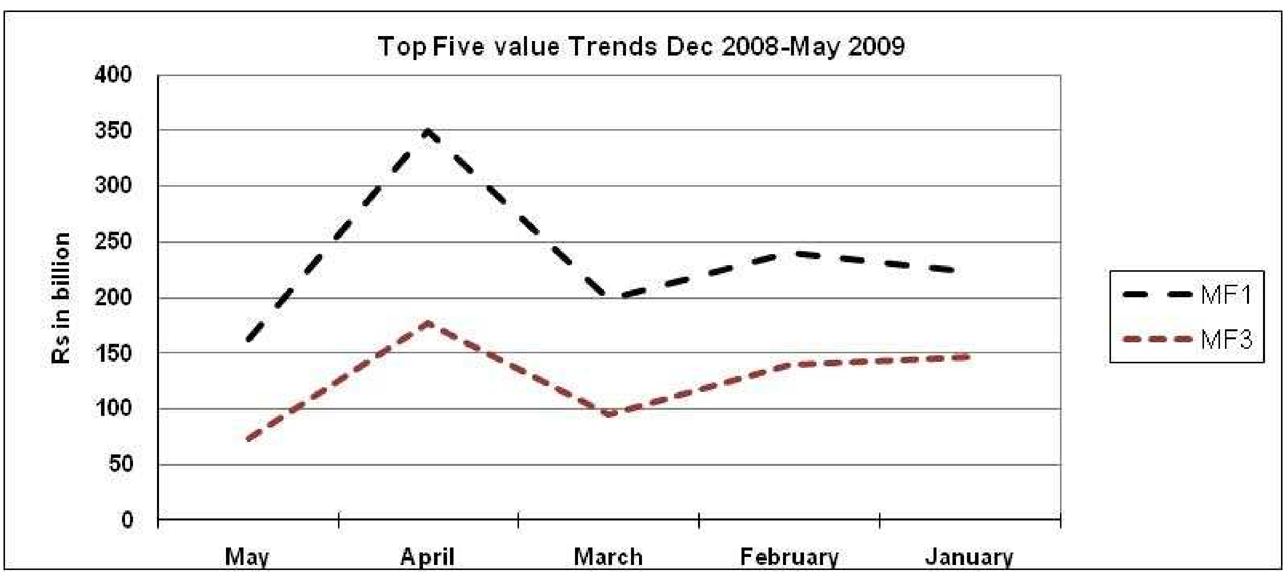
An examination of the above data shows that the industry has adjusted its position on a short term basis in tandem with the short term volatility of the market.

Top Five Companies: Trends in Value
December 2007 to May 2008

(Amounts in Rs billion)

Rank	May	April	March	February	January
1	161.99	350.21	198.73	239.68	223.64
2	-9.50	14.20	-9.35	-3.86	-27.85
3	73.39	176.85	95.01	140.14	146.51
4	-8.027	13.40	-32.58	16.59	-32.69
5	16.56	-14.25	13.19	-6.01	1.71





B. Trends in Sale of Securities

It is important to look at all funds and quantify the extent of movement in relative terms. Two measures were devised for this purpose. For each fund under study, a ratio of the number of scripts dealt with to the number of scripts held by it in a given period was calculated. The ratio was calculated on the base (December 2007 and December 2008 respectively) as well as on the new purchases during the period of study.

Period: December 2008 to May 2009: Quantity sold

STATISTICS ON PERCENAGE SOLD ON THE BASE*

ALL FUNDS

Average no. of securities with sale transaction	143
Quantity sold	**Average % of sale transactions**
More than 50%	45.70%
75% - 100%	38.56%

**Stocks held in December*

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The absolute numbers for the quantity of stock sold by the Mutual Funds during the period of December 2008 to May 2009 are glaring as approximately 45% of the time the industry has sold more than 50% of the quantities held by it in the base month of December. The number for quantities sold above 75% also stands out as it is slightly above 38% of the base quantity held in the month of December.

Period: December 2008 to May 2009: Quantity sold

STATISTICS ON PERCENTAGE SOLD ON THE BASE*

TOP TEN FUNDS

Average no. of security with sale transaction	201
Quantity sold	**Average % of sale transactions**
More than 50%	38.79%
75% - 100%	29.95%

BOTTOM TEN FUNDS

Average no. of security with sale transaction	100
Quantity sold	**Average % of sale transactions**
More than 50%	45.50%
75% - 100%	41.19%

**Stocks held in December*

A first cut look at the numbers brings out the fact that the bottom ten funds have heavy volatility but deal in far lesser number of stocks while the top ten funds deal in double the number of stocks and trail slightly behind the bottom ten in terms of volatility. The overall fund numbers being a simple average, it is obvious that the top ten funds have a bigger role to play in contributing to the industry volatility.

The researcher also dealt with data that had investments in foreign securities and funds not reported by the industry. The calculation of volatility in value terms trails with the quantity data despite the fact that value is also affected by market volatility.

On an average the BSE sensex had a volatility of 24.5% during December 2007 to May 2008 as against 32% during the period December 2008 to May 2009.

Period: December 2008 to May 2009: In value terms

STATISTICS ON PERCENTAGE SOLD ON THE BASE*

ALL FUNDS

Average no. of securities with sales transaction	156
Value sold	**Average % of sale transactions**
More than 50%	41.79%
75%-100%	34.29%

**Stocks held in December*

The above table clearly brings out the fact that value trends are not in deviation from the quantity trends, showing that the market volatility was “ridden” by the Mutual Fund industry.

Period: December 2008 to May 2009 : In value terms

STATISTICS ON PERCENTAGE SOLD ON THE BASE*

TOP TEN FUNDS

Average no. of securities with sales transaction	237
Value sold	**Average % of sale transactions**
More than 50%	34.82%
75% - 100%	26.51%

**Stocks held in* December

The top ten funds have contributed tremendously to the overall volatility as the quantity of stocks that they dealt in were more than twice the average on the back of the highest amount of assets under management that they enjoyed. The number of over 34% instances where above 50% value has been sold in a period of six months, clearly indicates a high level of volatility among the biggest funds.

STATISTICS ON PERCENTAGE SOLD ON THE BASE*

BOTTOM TEN FUNDS

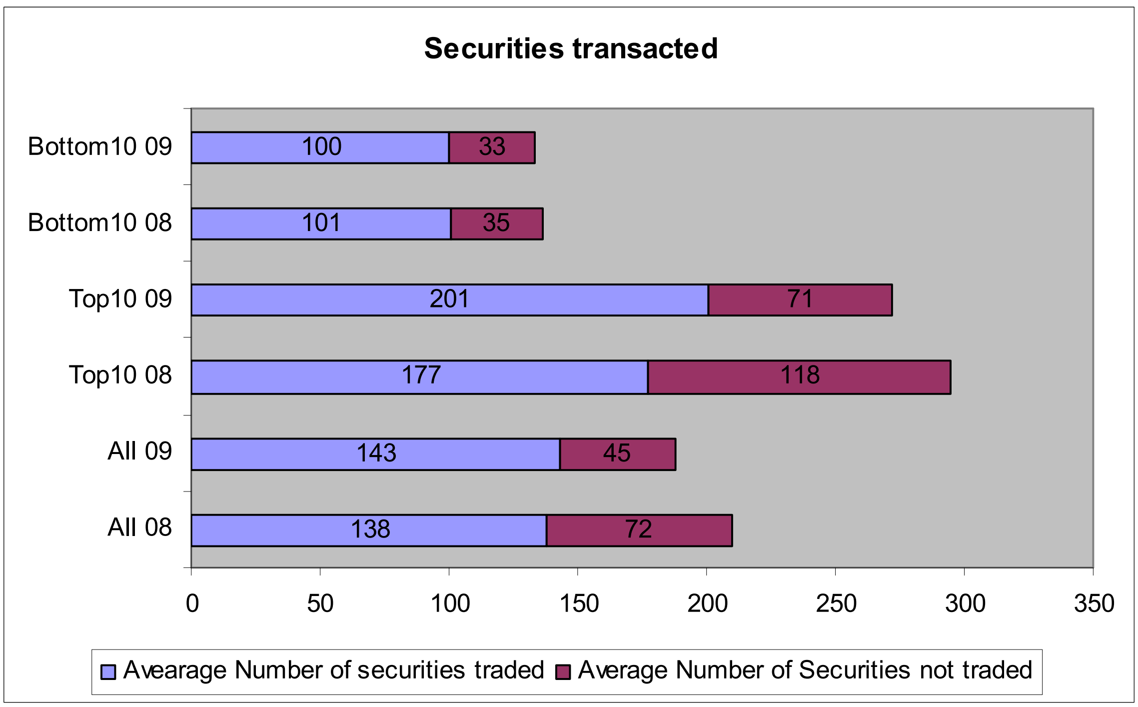
Average no. of securities with sales transaction	102
Value sold	**Average % of sale transactions**
More than 50%	42.17%
75%- 100%	37.43%

**Stocks held in December*

A higher level of volatility has been observed in the bottom ten funds as both the numbers 42% and 37% of sale instances are higher than the average. However, these numbers have to be viewed keeping in mind the value of the funds and the number of stocks that these funds deal in.

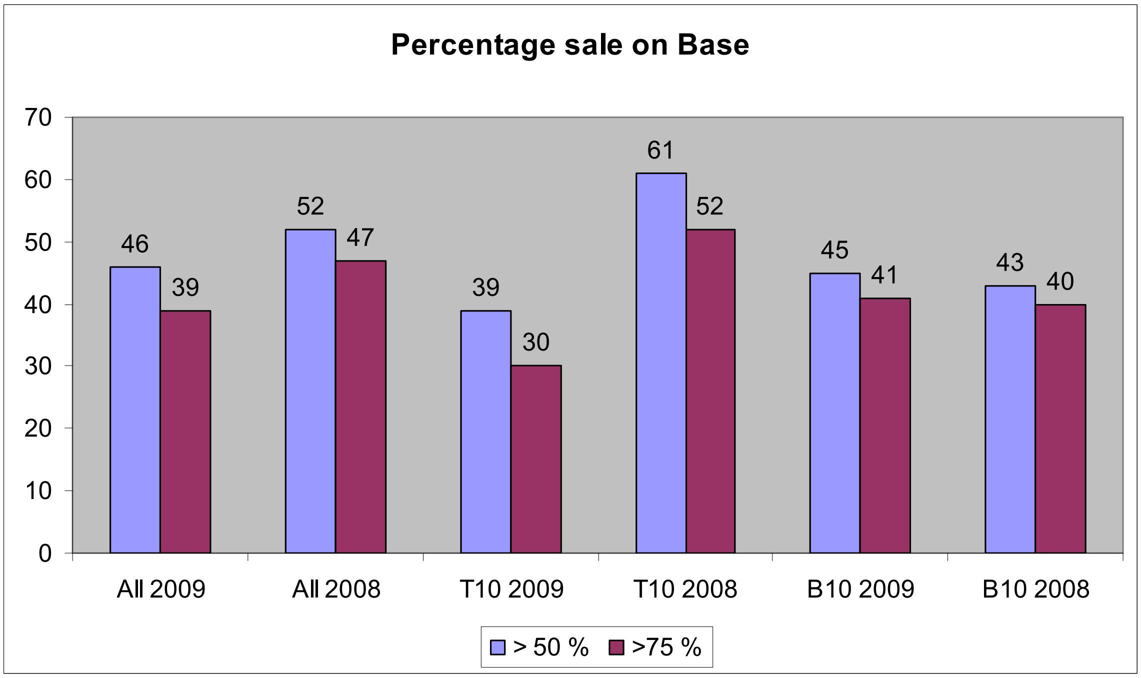
Let us first look at the trends in the number of securities transacted by the mutual funds during the period of study. As shown in the following table, the average number of securities held by all funds was 210 and 188 in 2008 and 2009 respectively. Of these the funds were traded on an average of 138 and 143 securities, which amounted to 66% and 76% respectively. As compared to 2008, on an average the funds held a lesser number of securities and traded in a larger number of securities in 2009. While a similar trend is observed for the top ten funds the bottom ten funds have not shown any notable change.

Securities	All Funds		Top 10 Funds		Bottom 10 Funds	
	2008	2009	2008	2009	2008	2009
Average Number of securities traded	138	143	177	201	101	100
Average Number of Securities not traded	72	45	118	71	35	33
Total Number of Securities	210	188	295	272	136	133
Percentage of securities traded	66	76	60	74	75	75



C. Trends in Percentage Sale on Base

If we look across funds and try to explore their investment pattern, it appears that many funds traded heavily in the relatively short period of six months. We thus look at the quartiles. The results are presented in the following chart.



For each fund under study, the number of scripts undergoing sale transactions were totalled. The number of transactions which resulted in a sale of more than 50% of the base quantity (December quantity) was ascertained and a percentage of such transactions on the total number of transactions was calculated. When a simple average was taken across funds it was found that on an average, 46% of the transactions involved a sale of more than 50% of the base quantity for the period of December 2008 to May 2009. For the same period, an average of 39% transactions by all mutual funds taken together involved a sale of more than 75% of the base quantity. In many cases, 100% quantity was sold.

The percentages were even higher in the previous year. For all funds, on an average, 52% of the total sale transactions involved sales of more than 50% of the base month quantity, while 47% involved more than 75% of the base month quantity.

The profile of the mutual fund investor consists primarily of wage earners who invest their money for a long term return. Mutual Funds are thus expected to take a long term view and provide steady returns. The percentages of sales on base appear to be way above average. The bottom ten funds have not shown much variation in their sale on base percentages over the two years. The trend in case of the top ten funds is quite pronounced. The transactions amounting to more than 50% sale on base were 39% this year as compared to 61% last year. The number 61% implies that on an average 61% of the transactions undertaken by the top ten mutual funds involved a sale of more than 50% of the base quantity. The transactions involving sale of more than 75% of the base came down from 52% last year to 30% this year.

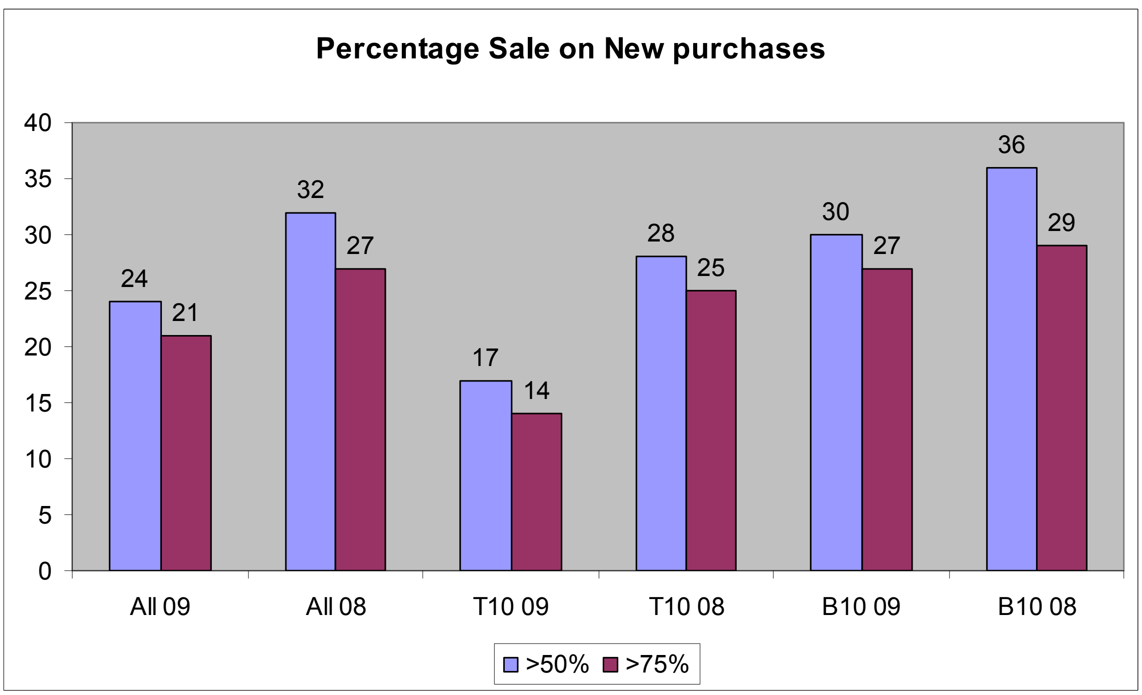
The last year's data indicates that the top ten funds sold high quantities more often than the bottom ten funds. The trend reversed this year with the top ten funds selling high quantities less often as compared to the bottom ten funds.

D. Trends in Percentage Sale on New Purchases

It was observed that the funds are not only selling huge quantities from the base but are also selling from the new purchases. Percentage of sale on new purchases was calculated for each fund and then a simple average was taken.

In 2009, bottom ten funds had more transactions with high percentage of newly purchased shares being sold. On an average, 30% of the transactions involved sale of more than 50% of the newly purchased quantity. The percentage was 17 and 24 for top ten funds and all funds respectively. For all funds taken together, on an average 21% of the transactions involved a sale of more than 75% of the newly purchased quantities. The corresponding numbers for top ten and bottom ten are 14% and 27% respectively.

In 2008, all the percentages were higher, implying that there were more short term purchases last year. On an average, for all funds last year, 32% of the transactions involved a sale of more than 50% of newly purchased quantities. Out of these transactions, about 84% (i.e. 27% of the total transactions) involved a sale of more than 75% of the newly purchased quantities. These percentages were less than average for the top ten and more than average for the bottom ten funds.



The overall trend is that the current period under study shows lesser short term sales as compared to the previous year.

The trends in the above chart show subdued sale percentages in the current year as compared to those of the previous year for stocks that were purchased during the six months under review.

This could be indicative of mutual funds going for “value investing” rather than “momentum investing”.

E. Sector Exposure

Another way of looking at investment styles is to look at the sector exposure of different funds. The researchers looked for trends in sector exposure in terms of number of funds moving in or moving out of a particular sector. Sale of large quantities was taken as a movement away from a sector and huge buying was taken as entry into a sector.

For the period December 2008 to May 2009 seven sectors saw many mutual funds buying into them. These sectors were Power, Cement, Fertilizers, Oil & Gas, Consumer Durables, Finance and Telecom. More than 80% of the funds indicated a clear interest in these sectors which was apparent from their huge net purchases.

The sectors that a lot of funds quit were Textiles, Entertainment and Shipping. About 60% of the funds indicated loss of interest in these sectors through heavy selling.

There is a third group of sectors that witnessed a mixed reaction from the funds. The sectors viz Banks, Metals and Electronics saw a movement where about 40-50% of the funds made heavy purchases whereas an almost equal number of funds showed signs of exit.

5. Summary and Conclusions

As the majority of the investors who invest in mutual funds are salaried individuals or individuals that own SMEs, the hypothesis that the Indian Mutual Fund industry would have a long term investment horizon, has now been repealed by the observations made in this paper.

The factors that would be considered to support this research are:

1. The average number of stocks held by the mutual funds was high as compared to the average number of stocks held by fund houses in mature markets.

2. As per the tables in this paper the many above-average positions taken by some of the mutual funds indicate that the industry was moving in tandem with the short term volatility of the market rather than having a long term strategy of buy and hold.

3. When one observes the percentage of stocks sold from the base position in a short span of six months the numbers are definitely above average for the period December 2008 to May 2009. The period December 2007 to May 2008 was very critical as it was immediately followed by downturn in the market. The numbers for this period are higher than the current period showing that the situation was the same in the previous year.

4. The sector investment movements showed some sectors being favored by a large number of funds in tandem. Some sectors have very close number of funds entering and exiting showing a mixed bag of movement. The sectors that show large movement of entry is heavily influenced by the top ten funds as they have an exact mapping of those sectors.

At the FICCI conference held in Mumbai In 2008, Mr Bhave, SEBI Board Chairman, had recommended that a supervisory committee be set-up at the SEBI level that would set up investment norms with regard to holding period for stocks owned by them for the Mutual Fund Industry. The researchers would conclude by stating that the said recommendation be implemented at the earliest for the Mutual Fund industry.

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