MUTUAL FUNDS AND OFFSHORE FUNDS IN INDIA

Dr S A Dave

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THE A. D. SHROFF MEMORIAL TRUST
"Piramal Mansion," 235, Dr. D. N. Road,
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OBJECTIVES

(i) Publication of one or more books in English, Hindi, and regional languages annually on some of the great builders of Indian economy aimed primarily at educating the younger generation in high standards of building the national economy as practised by those great entrepreneurs and placing the example of their lives for emulation by India's youth.

(ii) Organising one or more memorial lectures annually on subjects which were of interest to the late Mr. A. D. Shroff, namely, banking, insurance, and industrial finance, the subjects to be chosen in rotation, and the lectures to be delivered by persons eminent in these fields.

(iii) Awarding annual scholarship or scholarships to outstanding student or students in the field of management.

(iv) Instituting a prize to be known as The A. D. Shroff Memorial Prize for the student standing first in Banking at the Sydenham College of Commerce, Bombay.

(v) Doing all such acts, matters and things as are incidental or conducive to the attainment of the above aims or objects or any one or more of them; and

(vi) Without prejudice to the above charitable objects or any of them, the TRUSTEES shall have the power to spend, utilise and apply the net income and profits for the charitable object of education or such of the TRUST FUND for the charitable object of education or such other objects of general public utility not involving the carrying on of any activity for profit as the Trustees may think proper, it being the intention of the SETTLOR that the income and/or corpus of the Trust Fund shall be utilised for all or any of the aforesaid charitable objects without any distinction as to caste, creed, or religion.

A. D. SHROFF (1899-1965)

A. D. Shroff's achievements in the field of business, industry and finance were many and varied. A large number of enterprises owe their orgin and development to him. As an economist, his predictions have proved right over the years. Through the Forum of Free Enterprise, which he founded in 1956, as a non-political, educative organisation, he sought to educate the public on economic affairs. It was his firm conviction that a well-informed citizenry is the foundation of an enduring democracy.

George Woods, former President of the World Bank, paid the following tribute to A. D. Shroff:

> "In every age and in every society men must express anew their faith in the infinite possibilities of the human individual when he has freedom to develop his creative talents. For this is in large part how the message of freedom is passed from generation to generation. A. D. Shroff spoke eloquently in a great tradition and thanks to him we can be sure that other great men of India will continue to speak this message in the unknown context of our future problems."

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INTRODUCTION

The late Mr. A. D. Shroff was an institution by himself, and his views on economic issues were highly regarded both in India and abroad. A man of great foresight, courage and conviction, he was a pioneer in many fields and made his impact on the Indian economy in a significant manner. His contribution in the areas of banking, insurance and industrial finance are specially noteworthy.

To prepetuate his memory, one of the activities of The A.D. Shroff Memorial Trust is to arrange an annual public lecture, by rotation, on subjects related to Banking, Insurance, and Industrial Finance.

The 1991 Lecture in this Series was delivered by Dr. S. A. Dave, Chairman of the Unit Trust of India, and former Chairman of the Securities Exchange Board of India (SEBI). He has been associated with several financial institutions over the years, and his views are heard with great respect by the general public as well as by all concerned.

Dr. Dave chose the subject "MUTUAL FUNDS AND OFF-SHORE FUNDS IN INDIA", a relatively new field which is arousing interest not only among the investing public but also among the students of economics in all its aspects and the fiscal authorities as well.

The Trustees are happy to reproduce the text of this learned Lecture in book form in the hope that it will stimulate. debate and discussion among a wider audience and also attract well-deserved attention at a national level.

Bombay
19th March 1991

N. A. Palkhivala
Chairman
The A. D. Shroff Memorial Trust

Mutual Funds and Offshore Funds in India

Dr. S. A. Dave

I am particularly happy in paying my homage to A D Shroff through this lecture on two counts. First, unlike others who knew him personally and for whom he was a life-time legend, I rediscovered him in his full splendour after he was no more. We are children of the planning era and to us, the students of economics, the word planning provided tremendous excitement in our university days in fifties. We were then fed on Marx, Soviet Planning, Socialism, Mahalonobis model and looked forward to the 'next generation' days when all our ills would be over. Free enterprise, at that time, appeared to us as the cause of all our problems, and not a remedy. It required tremendous courage of conviction, a clear and bold vision, and unwavering faith in individuals, which inspired a man like A D Shroff to set up Forum of Free Enterprise in 1956. His true greatness unfolded before me, and many others like me, over time as we witnessed that our God if not failed, had not delivered what was expected. There is considerable rethinking presently going on. We all are sincerely grateful

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This is the text of the Annual Public Lecture delivered under the auspices of the A.D. Shroff Memorial Trust in Bombay on 7th February 1991. Dr. Dave is Chairman of Unit Trust of India (UTI), and has earlier held a number of important posts in the field of finance such as Chairman, Securities & Exchange Board of India (SEBI), and Executive Director of Industrial Development Bank of India (IDBI).

to the A D Shroff Memorial Trust for keeping his memory alive.

Secondly, I have chosen to speak on mutual funds, as they can survive and thrive only if they can live up to the hopes and trust of their individual members. As one associated with the Unit Trust of India, world's largest mutual fund enjoying trust of about ninety lakh unitholders, I feel there could hardly have been a better forum to talk about institutions whose very existence and raison de'tre is Trust of individuals.

Though called by different names such as mutual fund, Unit Trust and investment company, the essence of this institution is to professionally manage funds provided to them by others, and return back to them whatever income is earned on these funds, after deducting reasonable management fees. Basically, these institutions are professional fund managers, managing funds of individuals and bodies who may not have such high degree of expertise; or may not have sufficient time to cope up with the complexities of various investment instruments, tax laws, corporate performance, stock market behavior; or whose savings may be too small to take advantage of a widely diversified and growth oriented portfolio on the market. There have been times on the market, when to purchase the minimum sized trading lot of a good growth share, one will have to invest more than Rs. 25,000. It would be a prohibitive figure for many small savers. For them, the only way of taking advantage of the prosperity of such companies would be through an indirect route by subscribing to capital of some mutual funds. By subscribing to an appropriate scheme of a mutual fund, not only he may be able to take advantage of growth in scrips in which he could not have otherwise invested, but he may be able to get a balanced, well diversified portfolio which could considerably reduce his exposure to risk. Thus, by subscribing to the capital of mutual funds, an individual can have benefits of diversified portfolio and risk pooling, but, above all services of full-time professional management. The subscribers to a mutual fund hope to get a higher return on their investment than would have been possible by their own efforts by subscribing to some alternative instruments.

A typical individual saves out of his current income, to meet larger future requirements of income for occasions such as education, marriage, ill-health, purchase of house, car, appliances etc. Some of these needs can be foreseen and well-planned, but some can only be in the nature of unforeseen contingencies. He looks for safety, liquidity and some yield on his savings. Larger the amount of his savings, greater would be the concern for higher returns, while at the same time, higher his ability to take risks. A saver with excessive concern for safety and liquidity may prefer to keep his savings in the form of cash and be prepared to sacrifice yield. This may, in general, be true of very small savers. But as the volume of savings increases one may be prepared to sacrifice some liquidity and go for some yield by way of saving deposits or recurring deposits, or other instruments with institutions which can be considered totally safe. Willingness to sacrifice liquidity for higher but unsafe yields would come only after enough provision for liquidity at safe yield is made. And risk-taking for higher yields into unsafe instruments like shares would generally come only after enough savings are invested into high yield but reasonably safe instruments. The ability to take risk for higher yield would grow directly in proportion to the quantum of savings of an individual. As a general proposition, a saver would move from one end of the spectrum as a cash-saver into saver in risky assets at the other end, and within that from short term maximiser of yield, to medium and long term maximiser, directly in proportion to the size of his savings. The same saver, at any point of time, may invest in all instruments, from cash to highly-risky shares, but the proportions of his savings into no-risk to high-risk instruments will vary directly with the size of his savings. Risk taking essentially would be a characteristic of the large savers.

While this may be a typical behavior of a rational saver, the capital market consists of savers who defy all theories, take high risks, and can be classified into gamblers, speculators, short-term maximisers etc. Their strength is not so much capital adequacy, but instinctive behavior, and skills which drive them to take high risks for high gains. Their numbers is not insignificant, and they play an important role and exercise fair amount of influence on the day-to-day behavior of the stock market. They are responsible for considerable volatility of the market and contribute to its fragility.

Mutual funds, as professional managers, take into cognizance diverse income needs of diverse savers, and respond with different schemes or funds as they are called abroad. A typical company (eg. Unit Trust of India) may float several funds, focussed on typical needs of savers. Unit Trust of India, for example, has Fund for children, for insurance linked savings, for retired people, for charitable trusts, for capital gains and equity funds for risk takers in search of high yields. LIC has concentrated on Funds which include provisions for life cover. General Insurance Corporation recently has come out with a Fund which provides home insurance policy. It would be a Fund's desire to mop up as large amount of savings of its loyal investor as possible through its various schemes.

There are, outside India, companies which have floated property funds, art funds, money market funds, commodity funds, energy funds etc. In the past six years, in UK, companies have launched 'ethical', 'ecological and environmental' or green funds. These funds typically avoid investment in what may be considered socially undesirable activities such as tobacco, alcohol, armaments and nuclear power. Some funds would not invest in companies with activities in undesirable political regimes such as South Africa. Typical environmentally beneficial companies would be companies which are committed to pollution control, or to manufacturing products which cause no environmental damage.

Basically, however, the funds aim at providing regular income, or growth with less emphasis on annual distribution, or a combination of both. The objective of growth funds is to build up capital appreciation and distribute it at the time of redemption. As a normal rule, no Fund would assure a pre-determined return over the life of the Fund, but in India, we have evolved our own pattern of growth, and the mutual funds declare an assured moderate return at the time of the launching of the Fund, with no one providing any guarantee for it. So far these yields have been honoured and there is not a single case of Funds not being able to meet their assurances. The certainty of yield has been mainly instrumental in attracting large flow of funds from the household sector to mutual funds under these schemes. While this is certainly an unconventional practice, and would be generally frowned upon by the regulating agencies in other countries, it has to be noted that investors in India prefer considerable certainty regarding yield under income funds, and even like to have cheques for future dividends in advance.

While the mutual funds endeavour to offer higher yields than available on alternative instruments, and provide high degree of safety both for yield as well as return of capital, they also aim at providing continuous liquidity on their subscriptions. The funds are basically of two types : open-ended funds and the close-ended funds. The open-ended funds are those where the company continuously offers to sell and repurchase its units at prices which are based on the Net Asset Value (NAV) of the Fund. Under the close-ended funds, the units are offered for a limited period, are redeemed at the close of the pre-determined period, and are generally listed on the stock exchange where trading can take place at the market prices. Thus exit routes are available under both types of funds. The mutual fund itself will not ordinarily like to buy or sell these units under the close-ended schemes. In India, however, we have a system of close-ended funds which are not listed, but after an initial locking-in period of say, three years, the mutual fund may itself buy the units at pre-determined prices. There is, therefore, liquidity provision, but only after a certain period, and not at market determined prices. To this extent, Indian close-ended funds are less liquid and do not have easy exit routes, particularly in earlier years. But adequate disclosures regarding liquidity are made at the initial stage in the prospectus made available to investors and, therefore, can be considered to be typical Indian practices which have evolved over time and are well accepted by investors. Many a mutual funds also provide facilities for bank loans against the pledging of units. The Indian mutual funds, therefore, have attempted to provide all three requirements of good investment, namely safety, yield and liquidity in a fairly satisfactory way.

Mutual funds, as we currently know them, originated in the USA, and moved to the UK in the thirties. But the concept took root in India only in the sixties. Reacting to the need for a more active mobilisation of household savings to provide industry with investible resources, it was late Shri T T Krishnamachari who wrote to the then Prime Minister Pandit Jawaharlal Nehru outlining the need for an institution which would serve as the conduit for these resources to the capital markets. The Reserve Bank of India was soon enough entrusted with the task of creating this special institution and it seemed only poetic justice that Shri T T Krishnamachari, back in the cabinet as Finance Minister, was called upto to pilot the UTI Bill through Parliament. In what I consider a truly remarkable statement of both vision and purpose, Shri T T Krishnamachari told Parliament: "I would christen this attempt as an adventure in small savings and I am confident that we are embarking on this adventure with every hope of being successful." He went on to note that the UTI would provide "an opportunity for the middle and lower income groups to acquire without much difficulty property in the form of shares" and went on to add that while" it will be open to any person or institution to purchase these units,..... this institution is intended to cater mainly to the needs of individual investors..... whose means are small." He also observed, almost prophetically it would appear today, "we have considered it desirable to give them certain exemptions from the normal provisions of income tax law.... to provide (thereby) an additional incentive.... and to facilitate generally the dispersal and distribution of corporate shares among various persons."

In fulfilling this onerous mandate, the Unit Trust of India, India's first mutual fund has been through momentous times. In fulfilling its role as a mobiliser of the community's savings the record of the UTI speaks for itself. While the magic figure of Rs. 100 crores of sales mentioned by Shri T T Krishnamachari in Parliament took a long time in coming - fourteen years to be precise - the growth since then has been truly explosive. Total annual sales under all schemes have grown from Rs. 19 crores during the first year of operation in 1964-65 to Rs. 5569 crores as in 1989-90. In consonance with this impressive growth, the investible funds of the Trust have gone up steadily from about Rs. 25 crores in 1964-65 to over Rs. 17,650 crores by June end 1990. And the number of investors serviced has also kept pace. Unit holding aocounts rose from 1.3 lakhs in 1964-65 to 65 lakhs by June 1990, and further to 87 lakhs by the end of December 1990. The real growth came in the decade of eighties. The UTI has thus emerged as a singularly dominant institution on the Indian capital market. Having assiduously promoted the mutual fund cult through a series of open-ended and close-ended funds, it has donned the mantle of prime mover in creating awareness about and popularising equity cult among masses in the country.

I would like to mention about a very interesting, and in hindsight what I would regard, successful experiment we tried in popularising equity scheme among masses. In past, there have been perennial complaints to us that we did not provide enough capital appreciation to subscribers to the twenty-seven year old US-64 Scheme. It has provided steadily rising return and reached dividend of eighteen per cent for the last two years. The Scheme has unit capital of around Rs. 7,000 crores. In terms of annual yield, the Scheme has provided a yield of about 13.5 per cent in the last two years. The capital appreciation has been around forty per cent after twenty-seven years in the month of July which records seasonal rise throughout the year, as dividend date approaches nearer. We conceived an idea that we can provide an optional high growth scheme to the existing as well as prospective unitholders under US-64 Scheme. Fearing that a good response might come, we put a ceiling of Rs. 2,000 per unitholder, to be invested in select high growth equity. We also categorically announced, for the first time in India, that no dividend will be declared in the first two years and that it may be declared in subsequent years depending on income. I am pleased to inform you that over one million unitholders responded to the Scheme, largest under any scheme in a single year in India, with total amount exceeding Rs. 190 crores. We cannot fully satisfy aspirations of US-64 unitholders in a single year, but a beginning has been made. The more gratifying fact is that the response from economically backward states has been quite overwhelming, making us confident that the knowledge about prospects of equity and of potential prosperity of the capital market is growing rapidly among our people.

Offshore Funds

UTI has also been pioneer in putting India on the international map by floating two offshore Funds, India Fund in United Kingdom in 1986, and India Growth Fund which was listed on New York Stock Exchange in 1988. Both these Funds have outperformed market indices in India, though to-day, they are quoted at discount in London and New York stock exchanges like most of the country funds listed there. These funds, for the first time, have enabled foreign investors to participate in the growth of Indian capital market via the conduit of UTI.

While most developed countries observed the rapid development of domestic unit trust and mutual fund industry in third world countries, the benefits of diversifying into foreign stock markets was not available to them due to a variety of protectionist barriers to free flow of portfolio investments. It is here that the investment industry and investment professionals stepped in by responding with specialised packages that understood the vagaries and attractions of a particular offshore capital market. In this, we must pay special tribute to these modern day Columbuses for not only discovering the EXOTIC markets but also hardselling them to professional domestic Fund Portfolio Managers in developed countries who had hitherto never dreamt of parting with their money across borders to their lesser known, less developed but fast developing counterparts in the new markets. The basic driving forces have been:

- Increasing internationalisation of securities markets;

- Associated awareness by portfolio managers of diversification through excellent growth opportunities offered by fast growth economies of industrialising countries;

- Longer term opportunities and orientation. Sharp increase in Funds at the disposal of institutional investors in the US, Europe, Japan and Far East reaching over USD 3 trillion.

- The big swing of 1980s towards the bull market in equities worldwide; and
- More liberal investment attitudes of institutions, investment houses and Fund Managers which started looking beyond reduction in risk through diversification and expanding opportunities, but had primary motivation of ADDING VALUE at the margin through prospects of capital appreciation in these fast developing countries.

For certain international institutions, the thought that such investment can make simultaneously a real contribution to the development of the world could also have been a motivating factor. While this is difficult to quantify, one senses this more in some countries in Latin America and Asia. In some countries the extreme popularity of country funds could be traced to increased direct investment of capital in the development of domestic industry by capital rich countries wishing to relocate manufacturing facilities offshore. In the same context, for some reason countries on the geographical rim of the developed countries attracted the big first flush of offshore funds despite the fact that some of those markets could not have efficiently supported large portfolio investments.

Benefits to Host Country Economy: However, not all these factors would have opened the emerging capital markets to sustained capital flows, but for the fact that several governments during the late seventies and through the decade of eighties opened up their economies, and took steps to liberalise their capital markets and encourage foreign investment. I would briefly mention salient factors which encouraged the vast capital inflows in these countries.

- For most Latin American states and some countries in the South East Asia, it was the onset of the LDC debt crisis in 1982.

- External funding by way of soft loans and easy commercial loans of the early eighties became progressively harder to come by, prompting countries to foster nil and low interest bearing domestic instruments such as equity and convertibles. Most Asian and Latin American countries took major steps to liberalise their economies and encourage foreign flows on commercial considerations. India, which was till early eighties a highly insulated fort but for tightly regulated direct investments, permitted portfolio investment by non-resident Indians and has gradually liberalised the procedures for direct and portfolio foreign investments.

- Keeping in view the trend towards financial globalisation, Government were more willing and able to overturn isolationist financial and economic policies and find a new place for itself in the international markets. In effect these emerging markets initiated moves to remove the country's historical lack of competitiveness through removal and dilution of obstacles to foreign investment, particularly equity which does not burden corporate and national finances with fixed repayment obligations.

- The rapid economic growth trends in the Pacific Rim and Asia became visible through the growth of capital markets. Most Asian economies grew 2-4 times the world average in the eighties. While some Asian countries permitted domestic corporations to raise larger capital through the Eurobond markets, others like India, still persisted greenfield projects to tap domestic equity markets only for capital needs.

- Partly as a consequence of these reforms the total capitalisation of emerging markets grew from USD 81 billion in 1983 to USD 611 billion in 1990.

- In line with this growth returns of emerging markets also generally outperformed those of more established markets over the period. Besides having good growth characteristics for the better part of 1980s, emerging markets were extremely inexpensive in terms of price/earnings and price/book ratios. While many markets were undervalued relative to the rest of the world markets, today these markets seem to be returning to their more attractive valuations.

- The growth of emerging markets in the eighties was reflected in the increased issuance of country funds. These have grown more than tenfold in size from USD 700 million in 1985 to over USD 7 billion in 1990. According to Lipper Analytical Services, there are over 150 emerging market funds to choose from and the number is climbing rapidly. However, a number of newly listed country funds are those that would invest in already open markets like Germany, France and UK. While institutions have increased their exposure in absolute terms, it still remains marginal in terms of percentage which is variously put at between 0.1% - 0.2% of their assets.

Prospects and Scope for Newer Funds: The spectacular multifold growth of domestic and off-shore mutual fund assets of the last decade may not probably be matched in percentage terms in the developed world in the coming decade. However, I am certain that the domestic Indian mutual funds industry would continue to grow at a healthy rate during the decade of the nineties. Unlike most of South East Asian countries, India has seen a strong spurt in growth of domestic mutual fund industry. In addition to tapping individual savers and converting passbook holders - Indian mutual funds have attracted large sums of corporate surpluses in second half of eighties. Upto 1987 UTI was the sole offerer of mutual funds. With mutual funds still closed to the private sector, India saw the coming of age of the nationalised banker in the securities business. With Indian banks pushed into a corner in terms of outflow of deposits and forced to improve declining profitability, banks logically desired to enter the mutual fund business. Banks across the country are coming to the belief that their industry is destined to evolve into a major distribution channel for mutual funds. Owing to their sheer numbers, banks, over time, are likely to prominently involve in both sides of the capital market, managing the large equity and debenture issues as well as management of mutual funds.

I have dealt with this issue at some length since it underscores an important point that of the optimal solution to the problem of setting up of more offshore funds, and inviting foreign equity participation lies in the fact that India first develops strong local fund management and distribution experience. Few Asian emerging markets could parallel this development. This would be a healthy way to grow, and logically, therefore, one can expect to see large foreign participation in the coming years. The basic long term economic fundamentals are strong enough to attract foreign investors.

Those who disagree might say that some emerging markets are showing signs of a classic speculative bubble, whereas some others are growing at a steady pace. This, however, is not unlike classic stock market behaviour everywhere. Some equity markets did attract inflows of money in shorter periods which they could not digest instantaneously - particularly due to the narrow base of the domestic equity markets. But these are matters of intertemporal adjustments and quick policy responses. Indian capital market, for example, in the same time, grew in dimension with new supply of primary capital feeding the demand, but basically demand outstripping the supply, and weaker companies taking advantage of easily available green pasteurs. The situation demands a better and more effective regulatory framework, but nevertheless a thrust for further liberalisation and revitalisation. The situation calls for structural changes, fresher thinking and not merely tinkering with and extrapolation of traditional solutions.

India has since 1986 successfully offered four country funds which invest in the Indian securities markets in addition to at least 3 - 4 other funds that invest in India as part of Asia. At least two India Funds have gone in for additional issues increasing their size. Long term prospects for absorption of fresh Indian paper, as I mentioned earlier, are bright in view of commendable past performance of the India funds. Indian capital markets and the newer funds are evolving special tax structures attractive to foreign investors. Unit Trust of India is dealing actively with issues relating to innovation and performance as also building up of an infrastructure for high standards of Fund performance and introducing the state-of-art technology in portfolio management. A new Institute, UTI Institute of Capital Markets has been recently set up by UTI for this purpose. One of the significant positive fallouts of growth of mutual funds has been increasing awareness of better disclosures, stronger accounting rules and procedures and an approach based on knowledge and analysis rather than gossip and tips. It has made investors aware of their right to information and better services. It has made them more demanding.

Current Phase and Areas of Concern: Much of the impetus to the mutual fund industry in our country, we have to realise, is of recent origin. The move by the RBI to allow commercial banks, in spirit of increasing disintermediation, to move into activities related to the capital markets marks the beginning of the current phase of development of the mutual fund industry and at a broader level, of the financial services sector. Five banks, the State Bank of India, Canara Bank, Indian Bank, Bank of India and Punjab National Bank have moved to take advantage of this new area of licence (probably keeping in view their well spread historical portfolios). But it was the Abid Hussain Committee's unequivocal support to the concept, that could be accepted as something of a landmark. Amplifying its opinion on the matter the Committee noted "The most appropriate way of spreading the culture of equity... would be through some form of professionally managed institutionalised risk pooling mechanism. Mutual funds appear to be the most suitable vehicle for this..." and called for a greater number of mutual fund players. In addition to the above five banks, LIC and GIC have also entered the field of mutual funds.

Yet, it does appear that the mutual fund industry is presently destined for a phase of controlled expansion rather than an era of unbridled growth. Perhaps, it is rightly so as some recent events bear out. By international comparison, our mutual fund industry is still small. Resources of the mutual funds in equity, put together, may amount to no more than twelve per cent of market capitalisation in India. The UTI alone may account for eight per cent of this market capitalisation - making for a rather skewed asset distribution profile. Will India's mutual fund industry grow as large and broad-based as its counterparts in the developed financial markets? I do not know whether it would, but

I strongly believe it should, provided an effective regulatory framework is set up, barriers are selectively dismantled step by step, provident funds and other pension funds allowed to invest in mutual funds, and higher opertional efficiency is fostered through greater competition and better regulation. Larger participation by mutual funds, may not only enlarge the knowledge and analytical base of operations on the market, but put it squarely, diminish the hold of those who cannot see beyond immediate present and have no regard for rules or collective gains.

What we have now is but a handful of mutual fund players - just eight to be precise. We have to move towards a situation, where, within the near future there would be fifteen such players. All of them need not be large sized to begin with or for some time. We could actively encourage small sized funds of say Rs. 50 crores or so, and observe their performance. Their very size may impart into them an adroitness and flexibility which could result in good returns to investors and put those funds in better position to grow. Let every Fund grow, but in environments of fair disclosures, observance of fair practices and rules and total fairness to investors.

Tied up with the question of opening up of the mutual fund industry is the definition of the role of the joint and private sectors. In an economy where increasingly the role of the private sector in all areas of industry and commerce is being favourably looked upon, even welcomed, and the dynamism that private enterprise could impart to economic activity is being increasingly recognised, there would seem little justifications to exclude the private sector from entering the mutual fund arena. What are required as essential preconditions are an effective regulatory framework and compliance with a well enunciated takeover code. Our apprehensions today arise because the prevailing regulatory framework governing the operations of mutual funds and takeovers is inadequate. This inadequacy has already started causing concerns about the moves and the behaviour of the mutual fund industry - even when it is entirely in the public sector. Mutual funds should enjoy and live upto not only trust of investors, but also of industry, which is their main source of income. We all are looking forward to emergence of a strong Securities and Exchange Board of India, which would even handedly ensure that all players abide by rules and observe high standards of fairness.

As the mutual fund industry grows in physical presence and financial stature, not only are its infirmities becoming more obvious, but their impact on the growth and conduct of the secondary markets are becoming more pronounced, and at times, even controversial. Segments of the mutual funds industry have unfortunately not fully realised the true nature of the enormous trust placed in their hands by the investing public. A series of events in the secondary markets during 1986-1989, almost succeeded in driving household savings away from financial assets - specially from the market securities, the reasons for which are not very difficult to see. Unbridled speculation in the secondary markets, misconduct by brokers and even market rigging by companies ended up giving the secondary markets the reputation of a casino. And yet, at the same time, the mutual funds recorded handsome growth. The messages that the public sought to give were amply clear. Their demand was obviously for a relatively liquid, safe, income yielding investment, that earned a moderate appreciation to keep overall returns ahead of the rate of inflation. The mutual funds promised just that and fulfilled their promises. As a consequence, they managed to ensure a continuous and growing inflow of household savings into the primary and secondary markets, and thereby bring off an extremely difficult, and yet efficiently executed holding operation when the markets appeared to be tottering on the verge of collapse.

This trust, however, has to be continuously retained and enhanced. Concerned purely with fund raising without paying simultaneous and equally important need to its effective and efficient utilisation, segments of the mutual fund industry seemed to have unleashed a veritable tall claims contest. What started off essentially as a "guaranteed returns" sales pitch, has eventually resulted into degeneration of operating practices and procedures, quite contrary to well accepted medium and long term mutual fund behaviour patterns. Major fund managers admit about large scale diversions of finances away from the avowed objectives of the fund - viz. investments in the capital markets - to high yielding short term money market and inter-bank market transactions - all in a bid to live up to the honest, but tall promises made at the time of floatation. If some mutual funds floated by the banking sector commit the mistake of seeing a mutual fund involvement, as the only way to stave off the ill-effects of disintermediation on the banking sector, they are doing a greater disservice to the very concept of mutual funds. The ultimate response to disintermediation can only lie in better appraisals, improving customer service in existing businesses and interest rate revisions in their critical areas of operations, rather than trotting off on to new turf. Mutual funds are Trusts, the highest form of corporate enterprises, where fiduciary responsibilities and obligations are of the highest magnitude. For a common man, a mutual Fund is not only a Trust for his funds, but wrapped through these funds, it is also Trust of his hopes and aspirations.

Even more worrisome, probably is the fact, that the race to perform better has unalterably changed the time perspectives of fund managers. Instead of being long term or even medium term investors, there are many people in the business today whose time horizon is so short that it barely goes into the next settlement - in fact, in some cases barely into the next trading session. Some people have developed such a panache for quick trading and jobbing that even the jobbers among the broking fraternity would appear slow and flat footed in comparison. Such dexterity probably may impart great advantages in different conditions and arguably could be defended at individual levels. But the avowed objective of encouraging institutional participation in the stock exchanges really stems from the belief that they would be more rational, more knowledgeable, act with longer time perspective, and therefore, impart better health to the market than individual investors. Portfolio churning by the mutual fund industry can be extremely injurious to the health of the markets. Fund managers have to constantly remind themselves that while acting on behalf of investors they should endeavour to set precepts for, and not live by the precedents set by individual operators in the market place at large.

The Government guidelines on mutual fund behaviour that were released in June 1990 were essentially addresssing to these very issues. Mutual funds have to play a responsible role as innovators in the financial services sector, which is bracing itself for a new world of deregulation and globalisation in the nineties. It is only natural that they are at the centre of a lot of attention as trustees of public aspirations and funds. They, therefore, are expected to play the game fair by a well defined rule book. The new rules, framed "with a view to facilitating the development and orderly functioning of mutual funds in India" represent, in my opinion, only the first, but critical phase of a much needed regulatory regime. Equally crucial will be the second phase, which should aim at a standardisation of accounting procedures, periodic disclosures and a greater transparency in the actions of fund managers. The mutual fund industry, in the initial phase should share vital information both with the SEBI and its own unitholders. The US SEC guidelines for instance might appear appropriate. They provide that investment companies file reports with the SEC giving

a) detailed statistical information to aid in monitoring their operations, and

b) compliance information about investment company complexes.

The financial information for shareholders, even if not so exhaustive, has of necessity to include a balancesheet details of the amounts and values of portfolio securities as at the end of the accounting period; a statement of operations intemising every income or expenditure category entry exceeding 5% of total, a statement of changes in net assets itemised with respect to each charge or credit exceeding 5% and per share data.

The SEC obligations on record keeping in USA are very interesting and relevant. Investment companies are called upon to maintain complete business details for a period of six years, especially journals containing an itemised daily record of all purchases or sales of securities. The journal for each transaction should include the name of the securities, quantity, unit value, aggregate value, commission, market where traded, trade date, settlement date and parties to the transactions. Equally noteworthy is the SEC insistence that every investment adviser, depositor and principal underwriter for a registered investment company must maintain all appropriate documents covering his transactions with an investment company.

We in India are quite far from such onerous but well intentional statutory obligations. And yet, a true globalisation of the Indian markets will of necessity have to be preceded by a realisation by the entire mutual fund industry in fact, the entire securities industry that truthful disclosures, fair conduct and transparency in dealings are basic responsibilities of the entire financial services sector, and basic rights of investors.

An area of immediate concern for mutual funds is going to be servicing of increasing number of unitholders' accounts. UTI alone will add over three million unitholders in its portfolio during 1990-91. Other mutual funds may add another 1.5 million or so. While the mutual funds have been evoking good response to their various schemes, the banking system and postal system, two main infrastructural support services to mutual funds, have also to come up in tandem. The number of unitholders is increasing rapidly and it is bound to put significant pressure on services of these organisations. There have been reports of delays in their services. The service culture has yet to take firm roots in our service organisations, and people who seem to have plenty of time otherwise, have no time to attend to customer problems. The worst hit is a small investor. Smaller the man, larger become his problems in getting his rightful services. The mutual funds will have to ensure that services do not get deteriorated in their organisations, and that either the other supporting organisations move in tandem with them, or they devise systems and methods and alternative solutions which are capable of rendering prompt and efficient services to their investors.

Yet another area of great concern is large scale ownership of shares in a company by mutual funds. Though there are few mutual funds, funds at their disposal are quite large, and they are all seeking sizeable investment in top 100 scrips or so. The total ownership of shares by mutual funds in these companies, at times, acquire awesome proportions making many an industrialist feel quite uncomfortable. Introduction of more mutual funds can make market more competitive, but cannot obviate the fact that significant holdings will move in the hands of public mutual funds. This acts as constant fear in the minds of industrialists. The fear would appear to be more psychological than real, but it nevertheless exists, and has impact on the company's plans for future growth as well as means of financing for its growth. The intensity of this fear just cannot be alleviated by the assurance that institutions will always act in the interest of well-run management. A systematic solution will need to be evolved. The solution would apparently seem to lie in diminished holdings by mutual fund in these companies, but it cannot be considered in the best interest of mutual funds. They would prefer their Fund to invest in these securities. A solution may have to be sought in the domain of nonvoting shares and the willingness of the institutions to accept such shares. Care has to be taken, however, to ensure that the nonvoting shares increase the quantum of equity, are additional shares and not in substitution of normal voting shares. The debt-equity ratio must tilt in favour of equity as compared to current practices. Pending creation of such shares, mutual funds may have to act as investors, well-informed investors, willing to move out of the company if the market situation so warrants. But, by and large, the conduct of mutual funds should not give rise to any impression that they interfere in management.

That would inspire confidence among companies, and they should welcome them like any other investor. Intervention could only be in case of serious management lapses and failures. Then only the mutual funds could become 'Trust' of companies.

The A. D. Shroff Memorial Trust has no specific views on these economic problems. This publication is issued for public education and the views expressed are specifically those of the author.

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