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Measurment and Evaluation of Mutual Funds Performance

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Abstract

The mutual fund industry in India began with the setting up of the Unit Trust in India (UTI) in 1964 by the government of India .It is a mode of saving that attract the investor to make investment. A mutual fund in India can raise resources through sale of units to the public. It can be setup in the form of a Trust under the Indian Trust Act. It serves as a link between the investor and the securities market by mobilizing savings from the investors and investing them in the securities market to generate returns. It provide the investor with professional management of funds and diversification of investment among the securities offered by leading corporations, federal and state governments, and other entities. Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. Diversification reduces the risk because all stocks may not move in the same direction in the same proportion at the same time. It is not an alternative investment option to stocks and bonds, rather it pools the money of several investors and invests this in stocks, bonds, money market instruments and other types of securities. Buying a mutual fund is like buying a small slice of a big pizza.

Keywords: Mutual Fund, Mode of Savinig, Prons-Cons, Measurement of Mf, Performance of Mf.

Introduction

Introduction to Mutual Funds

A mutual fund is a financial intermediary that pools the savings of investors for collective investment in a diversified portfolio of securities. A fund is “mutual” as all of its returns, minus its expenses, are shared by the fund’s investors.

The Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 defines a mutual fund as a ‘a fund established in the form of a trust to raise money through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments’.

According to the above definition, a mutual fund in India can raise resources through sale of units to the public. It can be setup in the form of a Trust under the Indian Trust Act. The definition has been further extended by allowing mutual funds to diversify their activities in the following areas:

1. Portfolio management services.
2. Management of offshore funds.
3. Providing advice to offshore funds.
4. Management of pension or provident funds.
5. Management of venture capital funds.
6. Management of money market funds.
7. Management of real estate funds.

A mutual fund serves as a link between the investor and the securities market by mobilizing savings from the investors and investing them in the securities market to generate returns. Thus, a mutual fund is akin to portfolio management services (PMS). Although, both are conceptually same, they are different from each other. Portfolio management services are offered to high net worth individuals; taking into account their risk profile, their investments are managed separately. In the case of mutual funds, savings of small investors are pooled under a scheme and the returns are distributed in the same proportion in which the investments are made by the investors/unit-holders.

Mutual fund is a collective savings scheme. Mutual funds play an important role in mobilizing the savings of small investors and channelizing the same for productive ventures in the Indian economy.

Mutual Fund Industry

The mutual fund industry in India began with the setting up of the Unit Trust in India (UTI) in 1964 by the government of India. During the last 36 years, UTI has grown to be a dominant player in industry with asset of over Rs. 45,899 crores as of December 31, 2011. The UTI is governed by a special legislation, the Unit Trust of India Act, 1963. In 1987 public sector banks and insurance companies were permitted to set up mutual funds and accordingly since 1987, 6 public sector banks have set up mutual funds. Also the two insurance companies LIC and GIC established mutual funds. Securities exchange board of India (SEBI) formulated the mutual fund (regulation) 1993, which for the first time established a comprehensive regulatory framework for mutual fund industry. Since then several mutual funds have been set up by the private and joint sectors.1987 marked the entry of other public sector mutual funds. With the opening up of the Economy, many public sector banks and financial institutions were allowed to establish mutual funds. SBI established the first non-UTI mutual fund-SBI Mutual fund-in November 1987. This was followed by LIC Mutual fund, Indian Bank mutual Fund, and PNB Mutual Fund. These funds helped in enlarging the investor community and the investible funds. Mutual fund Industry now represents perhaps the most appropriate investment opportunity for most small investors. A mutual fund uses the money collected from investors to buy those assets which are specifically permitted by its stated investment objective. In INDIA mutual fund is constituted as a 'Trust' and the investor subscribes 'Units' issued by the fund, hence the term unit trust comes into the picture.

Mutual fund Industry form of a Management investment company that combines the money of its shareholder and invests those funds in a wide variety of stocks, bonds, and so-called money market instruments. The latter include short term investment such as United States Treasury bills and other federal securities, commercial paper, and bank certificate of deposits. Mutual funds provide the investor with professional management of funds and diversification of investment among the securities offered by leading corporations, federal and state governments, and other entities.

Organization of a Mutual Fund Industry Contains Entities such as

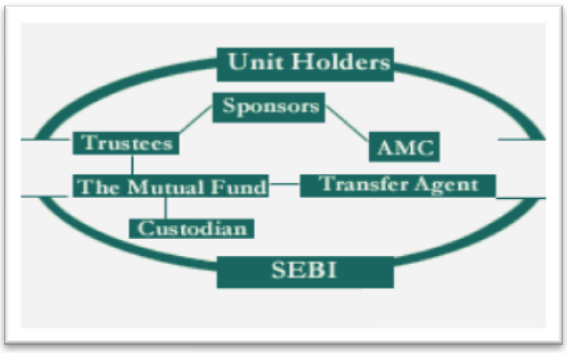


Fig. 1

Mutual Fund Shareholders

The Mutual Fund Shareholders, like the other share holders have the right to vote. The voting rights include, the right to elect directors during the directorial elections, voting right to approve the alterations investment advisory contract pertaining to the fund and provide approval for changing investment objectives or policies.

Board of Directors

The Board of directors supervise the functional activities, which include approval of the contract Asset Management Company and other various service providers.

Investment Management Company or Asset Management Company

This body handles the mutual fund portfolio as per the objectives and policies mentioned in the prospectus of the mutual funds.

Custodians

The custodians protect the portfolio securities. Mostly qualified bank custodians are used for mutual funds.

Transfer Agents

The transfer agent for the purpose of maintaining records and similar functions. The maintenance of the shareholder's accounts, calculation of dividends to the be disbursed, sending information to the shareholders about the account statements, notices, and income tax information. Some of the transfer agent sends information to the share holders about the shareholder transactions and account balances. They also maintain customer service departments in order the cater to the queries of the shareholders.

SEBI

The primary aim of the Securities Exchange Board of India is to protect the interest of the mutual fund investors. The SEBI has formulated several policies for better functioning and controls the mutual funds. In the year 1993, SEBI issued guidelines pertaining to the mutual funds. All mutual funds, private sector and public sector are regulated by the guidelines of the SEBI. The Asset Management Company managing the funds has to be approved by the SEBI

Concept of Mutual Fund

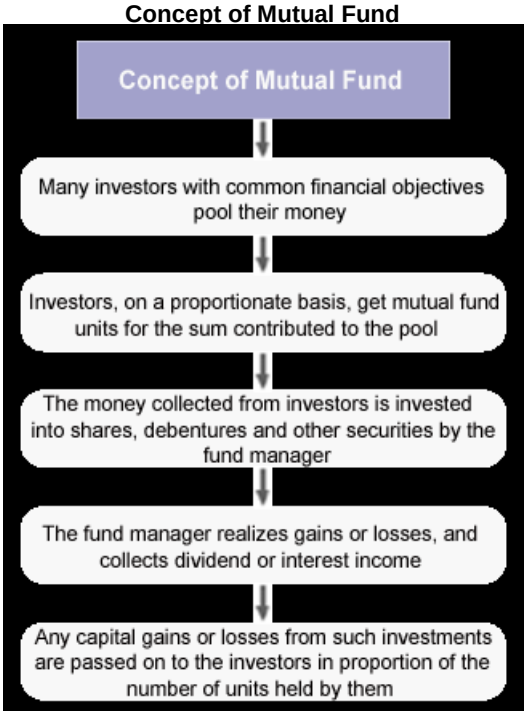


Fig. 2

Mutual fund is a mechanism for pooling the resources by issuing units to the investors and investing funds in securities in accordance with objectives as disclosed in offer document. Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. Diversification reduces the risk because all stocks may not move in the same direction in the same proportion at the same time. Mutual fund issues units to the investors in accordance with quantum of money invested by them. Investors of mutual funds are known as unitholders. The profits or losses are shared by the investors in proportion to their investments. The mutual funds normally come out with a number of schemes with different investment objectives which are launched from time to time. A mutual fund is required to be registered with Securities and Exchange Board of India (SEBI) which regulates securities markets before it can collect funds from the public.

In a mutual fund, many investors contribute to form a common pool of money. This pool of money is invested in accordance with a stated invested objective. The Ownership of the fund is thus joint or "mutual"; the fund belongs to all investors. A single investor's Ownership of the fund is in the same proportion as the amount of the Contribution made by him bears to the total amount of the fund. When a person buys "shares" of a joint stock company, the purchase makes the investors a part owner of the company and its assets. In the same way, when an investor subscribes to a mutual fund, he becomes part owner of fund assets. In fact, in U.S.A., a mutual is constituted as an investment company and an investor "buy into the fund", meaning he buys the share of the fund. In India, a mutual a mutual fund is constituted as a Trust and the investor subscribes to the "units" of a scheme launched by the fund, which is where the term Unit Trust comes from. However, whether the investor gets fund shares or units is only a matter of legal distinction. In any case, a mutual fund shareholder or units-holder is a part owner of the fund's assets. The term unit-holder includes investors in both the open-end and the closed-.end schemes. A mutual fund is a professionally-managed firm of collective investments that pools money from many investors and invests it in stocks, bonds, short-term money market instruments, and/or other securities.in other words we can say that A Mutual Fund is a trust registered with the Securities and Exchange Board of India (SEBI), which pools up the money from individual / corporate investors and invests the same on behalf of the investors /unit holders, in equity shares, Government securities, Bonds, Call money markets etc., and distributes the profits. The value of each unit of the mutual fund, known as the net asset value (NAV), is mostly calculated daily based on the total value of the fund divided by the number of shares currently issued and outstanding. The value of all the securities in the portfolio in calculated daily. From this, all expenses are deducted and the resultant value divided by the number of units in the fund is the fund's NAV.

NAV = Total value of the fund/No. of shares currently issued and outstanding vehicle for investing in stocks and bonds.

A mutual fund is not an alternative investment option to stocks and bonds, rather it pools the money of several investors and invests this in stocks, bonds, money market instruments and other types of securities. Buying a mutual fund is like buying a small slice of a big pizza. The owner of a mutual fund unit gets a proportional share of the fund's gains, losses, income and expenses.

Fig. 3

Mode of Investment

Systematic Investment Plan

This is a plan to invest in mutual funds by making smaller investments in monthly or quarterly rather than huge single time investment.

Single Time Investment

This is nothing but one time investment in selected mutual fund.

Here we are taking systematic investment plan as monthly plan for explanation. Yes! Systematic investment plan is better than any investment plan on mutual funds, because systematic investment will average your purchase units monthly. Single time investment buys units for fixed price; if stock market goes down your investment will goes down according to stock market. If you have chosen a systematic investment plan, when stock market goes down! You will get more units for less price, that mean you get more units for the same price which you are investing every month. So always prefer to invest in a systematic investment, because you know that the cumulative units average price is low where as compare to units, which you get by investing as a single time investment. This is my real experience that I am currently investing money as systematic investment plan in various sectors. I saw that when stock market went down from 21000 to 8000 on BSE index, my net worth is affected about 30 to 40% only, where as I have some funds that I invested as one time investment are affected about 50 to 60%. If you could have invested in mutual funds, am sure that you know the power of funds and how they can create a wealth for your future financial freedom. Most of the market researchers suggest that everyone should invest in a systematic investment plan to become a multi millionaire. If you plan to invest one thousand rupees a month for about twenty to thirty years, you

will get a more than one crore, if market yields just 12% per year.

Advantages of Mutual Fund

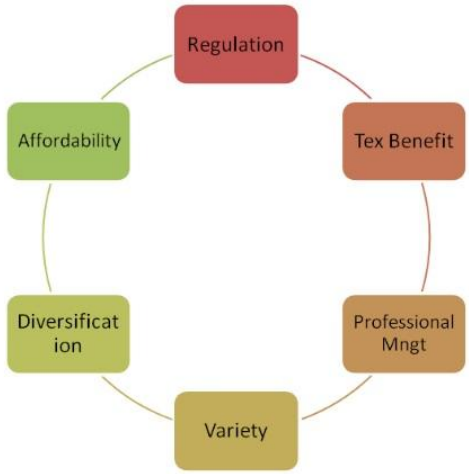


Fig. 4

If mutual fund is emerging as the favorite investment vehicle, it is because of many Advantages it has over the forms and avenues of investing, particularly for the investor who has limited resources available in terms of capital and ability to carry carry out detailed research and market monitoring. The following are major advantages offered by mutual funds to all investors.

Professional Management

The basic advantage of funds is that, they are professional managed, by well qualified professional. Investors purchase funds because they do not have the time or the Expertise to manage their own portfolio. A mutual fund is considered to be relatively less expensive way to make and monitor their investments.

Diversification

Purchasing units in a mutual fund instead of buying individual stocks or bonds, the investors risk is spread out and minimized up to certain extent. The idea behind diversification is to invest in a large number of assets so that a loss in any particular investment is minimized by gains in others.

Economies of Scale

Mutual fund buy and sell large amounts of securities at a time, thus help to reducing transaction costs, and help to bring down the average cost of the unit for their investors.

Liquidity

Just like an individual stock, mutual fund also allows investors to liquidate their holdings as and when they want.

Simplicity

Investments in mutual fund is considered to be easy, compare to other available instruments in the market, and the minimum investment is small. Most AMC also have automatic purchase plans whereby as little as Rs. 2000, where SIP start with just Rs.50 per month basis.

Disadvantages of Mutual Funds

Fig. 5

Fees and Commissions

The Mutual funds charge administrative fees to meet the daily expenses.

No Guarantees

All investments bear risk factors. The Mutual Funds are no different. It depends on the stock market. A fall in the stock market would trigger a fall in the value of the mutual fund shares.

Inefficiency of Cash Reserves

The Mutual Funds maintain big cash reserves, for situations such as a number of large withdrawals. The investors are provided with liquidity, and a major portion of the financial resources is maintained as cash, and it is not invested in some assets.

No Insurance

The Mutual funds are regulated by the central government. However mutual funds are still not insured against losses.

Trading Limitations

The Mutual Funds usually have high liquidity, but most of the mutual funds, such as open-ended funds, are bought or sold at the end of the day.

Loss of Control

In case, if the mutual funds are managed by the investor himself, the portfolio management may go bad and have an adverse effect on the earnings from the investment.

Classification of Funds

Structure Based Schemes

Open-Ended Schemes

These have no fixed maturity period. Open-ended schemes are available for subscription and redemption (purchase and sale) on an ongoing basis. The units are bought and sold at NAV related prices.

Close-ended Schemes

These schemes have stipulated maturity period. Typically, you can invest in them for between 3 to 10 years. These schemes are open for subscription only during a specified period at the time of their launch. In case of listed schemes, you can invest in the scheme at the time of the initial issue and thereafter units of the scheme can be bought or sold on the stock exchange where the scheme is listed.

Interval Schemes

Interval schemes are a combination of open-ended and close-ended schemes. These schemes

remain open for sale and http://www.pticindia.com/ mutual-fund-schemes.html -top repurchase only during a specified period.

Objective Based Schemes

There are six types of objectives based schemes.

Growth Schemes

Growth schemes are designed to provide optimum returns through capital appreciation over medium to long term. A major part of their fund are invested in equities. So, though there could be a decline in their value in the short- term these schemes deliver results in the long run. It is an ideal option for those in their prime earning years.

Income Schemes

If you are looking for regular and steady returns go for income schemes. These schemes generally invest in fixed income securities such as bond and corporate debentures. Their returns may not be as attractive as growth schemes but they are steady and less risky as compared to equity schemes. If you have retired or need capital stability and income to supplement your current earning opt for an income scheme.

Balanced Schemes

Balanced funds give you the best of growth and income schemes. A balanced fund invests both in equities and fixed income securities. Their returns are generally less volatile as compared to pure equity fund.

Liquid Schemes

Liquid schemes are also known as money market schemes. These schemes generally invest in safer short-term instruments such as treasury bills, certificated of deposit, commercial paper and government securities. It is a good idea to invest your surplus funds for short periods in liquid schemes.

Gilt Fund

If you are among the safe players, invest in a gilt fund. These funds invest exclusively in government securities which have zero credit risk. The NAVs of these schemes are determined by changes in interest rates and other economic factors as is the case with income or debt oriented schemes.

Tax Saving Schemes

If you are investing because you want to save tax, go for these schemes. They offer deduction from gross total income to the investors, at present, under Sec. 80C of the Income Tax Act. The investment made to any Equity Linked Saving Scheme (ELSS) are eligible for deduction up to Rs. 100000 every financial year. Tax saving schemes are growth oriented and invest predominantly in equities.

Special Schemes

Index Funds

Index Funds replicate the portfolio index such as the BSE Sensitive index, S&P NSE 50 index (Nifty), etc. These schemes invest in the securities in the same weight age comprising of an index.

Sector Specific Funds

Sector specific funds take advantage of the boom or expected upturn in a particular industry or sector by investing in them. So if software or pharmaceuticals is expected to do well, you have funds that invest in the stocks of only these sectors. The returns in these funds are dependent on the performance of the respective sectors or industries. While these funds may give optimized returns, they are riskier as compared to diversified equity funds that invest across different sectors.

Hedge Funds

A hedge fund is a fund that can take both long and short positions, use arbitrage, buy and sell undervalued securities, trade options or bonds, and invest in almost any opportunity in any market where it foresees impressive gains at reduced risk.

Various Investment Options in Mutual Funds Offer

To cater to different investment needs, Mutual Funds offer various investment options. Some of the important investment options include:

Growth Option

Dividend is not paid-out under a Growth Option and the investor realises only the capital appreciation on the investment (by an increase in NAV).

Dividend Payout Option

Dividends are paid-out to investors under the Dividend Payout Option. However, the NAV of the mutual fund scheme falls to the extent of the dividend payout.

Dividend Re-investment Option

Here the dividend accrued on mutual funds is automatically re-invested in purchasing additional units in open-ended funds. In most cases mutual funds offer the investor an option of collecting dividends or re-investing the same.

Retirement Pension Option

Some schemes are linked with retirement pension. Individuals participate in these options for themselves, and corporates participate for their employees.

Insurance Option

Certain Mutual Funds offer schemes that provide insurance cover to investors as an added benefit.

Risks Associated with Mutual Funds

Market Risk

It is also known as systematic risk in which the prices or yields of all the securities in a particular market rise or fall due to broad outside influences. When this happens, the stock prices of both an outstanding, highly profitable company and a fledgling corporation may be affected.

Interest Rate Risk

Changing interest rates affect both Equities and bonds in many ways. Investors are reminded that "predicting" which way rates will go, is rarely successful. A diversified portfolio can help in offsetting these changes.

Inflation Risk

Sometimes referred to as "loss of purchasing power." Whenever inflation rises forward faster than the earnings on your investment, one runs the risk of actually being able to buy less, not more. Inflation risk also occurs when prices rise faster than returns.

Exchange Risk

Many of the companies generate revenues in foreign currency or may have investments denominated in foreign currencies. Thus a change in exchange rate may have a positive or a negative on companies as well as on the funds which have invested in them.

Each Mutual Fund has a Specific Stated Objective

The fund's objective is laid out in the fund's prospectus, which is the legal document that contains information about the fund, its history, its officers and its performance.

Some Popular Objectives of a Mutual Fund are

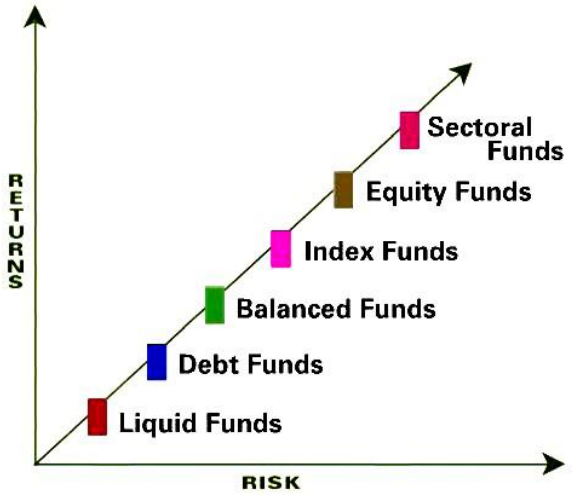
Fund Objective	What the fund will invest in
Equity (Growth)	Only in stocks
Debt (Income)	Only in fixed-income securities
Money Market (including Gilt)	In short-term money market instruments (including government securities)
Balanced	Partly in stocks and partly in fixed-income securities, in order to maintain a 'balance' in returns and risk

Performance Measures of Mutual Funds

Mutual Fund industry today, with about 34 players and more than five hundred schemes, is one of the most preferred investment avenues in India. However, with a plethora of schemes to choose from, the retail investor faces problems in selecting funds. Factors such as investment strategy and management style are qualitative, but the funds record is an important indicator too. Though past performance alone can not be indicative of future performance, it is, frankly, the only quantitative way to judge how good a fund is at present. Therefore, there is a need to correctly assess the past performance of different mutual funds.

Worldwide, good mutual fund companies over are known by their AMCs and this fame is directly linked to their superior stock selection skills. For mutual funds to grow, AMCs must be held accountable for their selection of stocks. In other words, there must be some performance indicator that will reveal the quality of stock selection of various AMCs.

Return alone should not be considered as the basis of measurement of the performance of a mutual fund scheme, it should also include the risk taken by the fund manager because different funds will have different levels of risk attached to them. Risk associated with a fund, in a general, can be defined as variability or fluctuations in the returns generated by it. The higher the fluctuations in the returns of a fund during a given period, higher will be the risk associated with it. These fluctuations in the returns generated by a fund are resultant of two guiding forces. First, general market fluctuations, which affect all the securities present in the market, called market risk or systematic risk and second, fluctuations due to specific securities present in the portfolio of the fund, called unsystematic risk. The Total Risk of a given fund is sum of these two and is measured in terms of standard deviation of returns of the fund. Systematic risk, on the other hand, is measured in terms of Beta, which represents fluctuations in the NAV of the fund. The more responsive the NAV of a mutual fund is to the changes in the market; higher will be its beta. Beta is calculated by relating the returns on a mutual fund with the returns in the market. While unsystematic risk can be diversified through investments in a number of instruments, systematic risk can not. By using the risk return relationship, we try to assess the competitive strength of the mutual funds in a better way.



Risk v/s. return
Fig.6

Measuring and Evaluating Mutual Funds Performance

Every investor investing in the mutual funds is driven by the motto of either wealth creation or wealth increment or both. Therefore it's very necessary to continuously evaluate the funds' performance with the help of factsheets and newsletters, websites, newspapers and professional advisors like SBI mutual fund services. If the investors ignore the evaluation of funds' performance then he can loose hold of it any time. In this ever-changing industry, he can face any of the following problems:

1. Variation in the funds' performance due to change in its management/ objective.
2. The funds' performance can slip in comparison to similar funds.
3. There may be an increase in the various costs associated with the fund.
4. Beta, a technical measure of the risk associated may also surge.
5. The funds' ratings may go down in the various lists published by independent rating agencies.
6. It can merge into another fund or could be acquired by another fund house.

Performance Measures

Equity Funds

The performance of equity funds can be measured on the basis of: NAV Growth, Total Return, Total Return with Reinvestment at NAV, Annualized Returns and Distributions.

Debt Fund

Likewise the performance of debt funds can be measured on the basis of: Peer Group Comparisons, The Income Ratio, Industry Exposures and Concentrations, NPAs, besides NAV Growth, Total Return and Expense Ratio.

Liquid Funds

The performance of the highly volatile liquid funds can be measured on the basis of: Fund Yield, besides NAV Growth, Total Return and Expense Ratio.

Concept of Benchmarking for Performance Evaluation

Every fund sets its benchmark according to its investment objective. The funds performance is measured in comparison with the benchmark. If the fund generates a greater return than the benchmark then it is said that the fund has outperformed benchmark, if it is equal to Benchmark then the correlation between them is exactly 1. And if in case the return is lower than the benchmark then the fund is said to be under performed.

To measure the fund's performance, the comparisons are usually done with:

1. Market index
2. Funds from the same peer group.
3. Other similar products in which investors invest their funds.

Conclusion

At last we can conclude that Mutual fund is a collective savings scheme. It play an important role in mobilizing the savings of small investors and channelizing the same for productive ventures in the Indian economy. It is a systematic plan. It generates fund so that employment increase which is beneficial for our economy. But it charge administrative fees to meet the daily expenses. All investments bear risk factors.

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