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Mutual Funds in Historical Perspective

1.1 Mutual Fund as a Financial Service

The popularity of mutual funds, and the important role they play in the financial system of many countries, is recognized all over the world. Mutual funds are an ideal medium for investment by small investors in the stock market. Mutual funds pool together the investments of small investors for participation in the stock market. Being institutional investors, mutual funds can afford market analysis generally not available to individual investors. Furthermore, mutual funds can diversify the portfolio in a better way as compared with individual investors due to the expertise and availability of funds.

Mutual fund investments have become a subject of great importance in the recent investment alternatives. It has more importance when investors are keen to diversify their investment to maintain a balance between investment growth and investment risk. Mutual funds maintain a balance between risk and return, provide the customers desired diversified investment portfolio and offer the benefit of high liquidity. For diversified investment solutions and liquidity advantage, investors need to invest in mutual fund. Before investing their money, investors need to carry out sincere study on the performance of mutual funds.

Investment is the process of putting money to work to earn income. Investing even a small amount can produce considerable growth over long period. Investors continuously plan for their investments to fulfil major needs like financial protection, career building, asset purchase, marriage, children's education, retirement funding etc. For this investors need to take decision regarding how much to invest? And where to

invest? To choose wisely, investors need to know investment options thoroughly. It is financial services institutions and intermediaries which help the investors for transforming saving into investment, production and growth. It is a mechanism or arrangement for the mobilization of funds, their transfer and allocation. A financial services intermediary provides scope for saving and investment through various financial products.

Mutual fund is an emerging financial services intermediary and has enormous value in the financial market. A mutual fund is recognized as a medium as well as long term investment option. There are large numbers of small investors, who are able to save and make investment in financial instruments, but majority of them lack expertise for saving and investment. Mutual fund provides numbers of mutual fund options for saving and investment for meeting the needs of retail (small) investors.

1.2 Mutual Funds and the Indian Economy

Indian economy is one of the fastest growing economies of the world and targeting a GDP growth of 9 percent. The saving of the country is now around 29 percent. Foreign investors are investing in Indian market because of it high growth potential. India's foreign exchange reserve is around US$ 305 billion. Inflation is at 5 percent which is considered good for developing economies. India is emerging economy and as the third pole in the global economy after the US and China. This entire favourable environment could not possible without the sound financial market. It is the financial market which finances economic development. It is the financial market which channelizes the saving of the people into the investment. Foreign investors, local institutions and mutual funds are now playing a bigger role.

The options available are to invest the money in stock market. But a common investor is not well informed and competent enough to understand the complexities involved in

the price movement of securities in the financial market. This is where mutual funds come to rescue them. In the US, near about 35 to 40 percent of the investments currently come through mutual funds while in India it is very negligible. With the stock markets progress mutual funds could not be far behind. Total assets under management of 42 major funds rose to ₹ 7,12,741 crore, according to the data published by the Association of Mutual Funds of India (AMFI). Mutual funds saw record resource mobilization as investors lined up to take advantage of the financial market boom.

Mutual funds are essentially investment vehicles where people with similar investment objective come together to pool their money and then invest accordingly. Each unit of any scheme represents the proportion of pool owned by the unit holder (investor). Appreciation or reduction in value of investments is reflected in net asset value (NAV) of the concerned scheme, declared by the fund from time to time. Mutual fund schemes are managed by respective Asset Management Companies (AMC). Different business groups, financial institutions and banks sponsors these AMCs, either alone or in collaboration with international firms. Several international funds are operating independently in India and some are expected to come in the future. Mutual funds invest according to the underlying investment objective specified at the time of launching a scheme.

So, investors have equity funds, debt funds, gilt funds and many others that cater to the different needs of the investor. Equity funds are as risky as the stock markets themselves, debt funds offer security. Money market funds offer the liquidity that is expected by big investors who wish to park surplus funds for very short-term periods. Balance funds cater to the need of investors having an appetite for risk greater than debt funds but less than the equity funds. The only relevant factor here is that the fund has to be selected keeping the risk profile of the investor because the products have different risks associated with them.

India's mutual funds have witnessed phenomenal growth over the last few years. Mutual funds would be one of the major instruments of wealth creation and wealth saving in the years to come, giving positive results. As India is targeting a GDP growth rate of 9 percent in the Eleventh Plan Period, the role of financial sector as well as the role of mutual funds industry in India is important segment of financial market for resource mobilization. The consistency in the performance of mutual funds has been a major factor that attracts many investors. The mutual fund industry growth is estimated at about 50 percent, much higher than that of bank fixed deposits which are growing at about 20 percent.

According to the Global Asset Management Report 2006, form Boston Consulting Group, India-managed assets will exceed more than US$ 1 trillion by 2015. This means an annual growth rate of 21 percent for the next years. The Indian mutual funds industry has been growing at a healthy pace of 16.68 percent in the past and the trend will move further. With the entrance of new fund houses and the introduction of new schemes into the market, investors are now being offered plenty of mutual fund choices. The total assets under management of mutual fund industry declined by 1 percent from ₹ 5,92,250 crore as on March 31, 2011 to ₹ 5,87,217 crore as on March 31, 2012 as published by AMFI. In 1987, its size was just ₹ 1,000 crore, which went up to ₹ 4,100 crore in 1991 and subsequently touched a figure of ₹ 72,000 crore in 1998. Since then, this figure has been increasing tremendously and stood at ₹ 7,30,361 crore as on July 31, 2012, thus revealing the efficiency of growth in the mutual fund industry.

It has generally been observed that as the GDP of a country starts moving up, the share of AUM as a percentage of household financials assets start to increase. As India's GDP is expected to maintain its growth rate, households will surely be holding more assets through mutual fund than ever before. The tremendous growth of Indian mutual funds industry is an indicator of the efficient financial market we are currently

having and the trust which investors have on the regulatory environment.

1.3 History of Mutual Funds: World

History of mutual funds has evolved over the years and very interesting for all the investors of the world. In present day, mutual funds have become a main form in investment domain because of its diversified and liquid features. Not only in the developed world, but in the developing countries different types of mutual funds are gaining popularity very fast. But, there was a time when the concept of Mutual Funds was not present in the economy. There is an ambiguity about the fact that when and where the mutual fund concept was introduced for the first time. According to some thinker, the mutual funds were first introduced in Netherlands in 1822. According to some other belief, the idea of mutual fund first came from a Dutch in 1774. In 1822, the idea was further developed. In 1822, the concept of 'investment diversification' was properly incorporated in the mutual funds.

The history of the mutual funds can be traced to the booming late 18th century markets in Amsterdam. The first 'pooling of money' for investment was made in 1774. After the 1772-1773 financial crisis, a Dutch merchant Adriaan (Abraham) van Ketwich invited investors to come together to form an investment trust. The goal of the trust was to lower risks involved in investing by providing diversification to the small investors. The funds invested in various European countries such as Austrian, Danish and Spanish economy. The investments were mainly in bonds and equity formed a small portion. The security was known as negotiate, an instrument very similar to the present day closed-end funds. This first negotiate, 'Eendragt Maakt Magt' invested in bonds issued by foreign governments and banks and in plantation loans in the West Indies. The trust was names Eendragt Maakt Magt, which meant 'Unity Creates Strength'.

The fund had many features that attracted investors:

1. It had an embedded lottery.
2. There was an assured 4 percent dividend, which was slightly less than the average rates prevalent at that time. Thus the interest income exceeded the required payouts and the difference was converted to a cash reserve.
3. The cash reserve was utilized to retire a few shares annually at 10 percent premium and hence the remaining shares earned a higher interest. Thus the cash reserve kept increasing over time—further accelerating share redemption.

Van Ketwich introduced his second negotiate 'Concordia Res Parvae Crescunt' in 1779, with more freedom in investment policy. The prospectus stated that negotiate (instrument) would invest in solid securities and those that based on decline in their price would merit speculation and could be purchased below their intrinsic values. Concordia Res Parvae Crescunt existed for 114 years and in 1893 it was officially dissolved. However, a War with England led to many bonds defaulting. Due to the decrease in investment income, share redemption was suspended in 1782 and later the interest payments were lowered too. The fund was no longer attractive for investors and faded away.

At the very dawn of commercial history, Egyptians and Phoenicians were selling shares in vessels and caravans in order to spread the risk of these perilous ventures. The idea of pooling money dates back to 1822, when groups of people in Belgium established a company to finance investments in national industries under the name of 'Societe Generale de Belgique' incorporating the concept of risk sharing. The institution acquired securities from a wide range of companies and practiced the concept of mutual fund for risk diversification. In 1822, King William I of Netherlands came up with a closed-end fund. In 1860, this phenomenon spread to England. In 1868, the Foreign and Colonial Government Trust of London was formed, which was the real pioneer to spread risk of investors over a large number of securities and was

considered as the Mecca of modern mutual funds. In 1873, Robert Fleming, established 'The Scottish American Trust'. Although, many nineteenth century British investment trusts invested in American stocks, the first American investment trust was the close-end Boston Personal Property Trust created in 1893. The Alexander Fund in Philadelphia was the first step towards open-end funds.

It was established in 1907 and had new issues every six months. Investors were allowed to make redemptions. The 1920's saw the creation of the first open-ended mutual fund, 'Massachusetts Investors Trust' in Boston. The fund went public in 1928. In the same year Scudder, Stevens and Clark launch the first no-load fund and the creation of the 'Wellington Fund', the first mutual fund to include a balanced portfolio of stocks and bonds. By 1929 there were 19 open-ended mutual funds competing with nearly 700 closed-end funds. The stock market crash of 1929 wiped out many highly leveraged closed-end funds and the small open-end funds managed to survive. The resultant round of 1930's financial legislation laid the groundwork for the contemporary mutual fund industry. The era saw the creation of the Securities and Exchange Commission (SEC), the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Investment Company Act of 1940 followed. The act set the legal framework for four types of registered investment companies in the United States i.e.

1. Open-end investment companies (mutual funds).
2. Closed-end investment companies (closed end funds).
3. Exchange-traded funds (ETFs).
4. Unit investment trusts (UITs).

The post-War period marked an era of substantial growth for the U.S. mutual fund industry. By 1951 there were more than 100 mutual funds in existence, and 150 more funds were added over the next two decades. At the close of the buoyant late 1960's stock markets, U.S. mutual funds held an average 87 percent of their assets in stocks. The ensuing major 1973-