A

Seminar report

On

Mutual Funds

Submitted in partial fulfillment of the requirement for the award of degree of MBA

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Preface

I have made this report file on the topic **Mutual Funds**; I have tried my best to elucidate all the relevant detail to the topic to be included in the report. While in the beginning I have tried to give a general view about this topic.

My efforts and wholehearted co-corporation of each and everyone has ended on a successful note. I express my sincere gratitude to …………..who assisting me throughout the preparation of this topic. I thank him for providing me the reinforcement, confidence and most importantly the track for the topic whenever I needed it.

Content

Introduction

A **mutual fund** is a type of professionally managed investment fund that pools money from many investors to purchase securities. While there is no legal definition of the term "mutual fund", it is most commonly applied only to those collective investment vehicles that are regulated and sold to the general public. They are sometimes referred to as "investment companies" or "registered investment companies". Hedge funds are not mutual funds, primarily because they cannot be sold to the general public.

In the United States, mutual funds must be registered with the U.S. Securities and Exchange Commission, overseen by a board of directors or board of trustees, and managed by a Registered Investment Advisor. Mutual funds are also subject to an extensive and detailed regulatory regime set forth in the Investment Company Act of 1940. Mutual funds are not taxed on their income and profits if they comply with certain requirements under the U.S. Internal Revenue Code.

Mutual funds have both advantages and disadvantages compared to direct investing in individual securities. Today they play an important role in household finances, most notably in retirement planning.

There are three types of U.S. mutual funds—open-end funds, unit investment trusts, and closed-end funds. The most common type, open-end funds, must be willing to buy back shares from investors every business day. Exchange-traded funds (ETFs) are open-end funds or unit investment trusts that trade on an exchange. Non-exchange traded open-end funds are most common, but ETFs have been gaining in popularity.

Mutual funds are generally classified by their principal investments. The four main categories of funds are money market funds, bond or fixed income funds, stock or equity funds, and hybrid funds. Funds may also be categorized as index (or passively managed) or actively managed.

Investors in a mutual fund pay the fund’s expenses, which reduce the fund's returns and performance. There is controversy about the level of these expenses.

History

The first mutual funds were established in Europe. One researcher credits a Dutch merchant with creating the first mutual fund in 1774.

Mutual funds were introduced to the United States in the 1890s, and they became popular in the 1920s. These early funds were generally closed-end funds with a fixed number of shares that often traded at prices above the portfolio value.

The first open-end mutual fund, called the Massachusetts Investors Trust (now part of the MFS family of funds), with redeemable shares was established on March 21, 1924. However, closed-end funds remained more popular than open-end funds throughout the 1920s. In 1929, open-end funds accounted for only 5% of the industry's $27 billion in total assets.

After the stock market crash of 1929, Congress passed a series of acts regulating the securities markets in general and mutual funds in particular. The Securities Act of 1933 requires that all investments sold to the public, including mutual funds, be registered with the SEC and that they provide prospective investors with a prospectus that discloses essential facts about the investment.

The Securities and Exchange Act of 1934 requires that issuers of securities, including mutual funds, report regularly to their investors; this act also created the Securities and Exchange Commission, which is the principal regulator of mutual funds. The Revenue Act of 1936 established guidelines for the taxation of mutual funds, while the Investment Company Act of 1940 governs their structure.

When confidence in the stock market returned in the 1950s, the mutual fund industry began to grow again. By 1970, there were approximately 360 funds with $48 billion in assets. The introduction of money market funds in the high interest rate environment of the late 1970s boosted industry growth dramatically. The first retail index fund, First Index Investment Trust, was formed in 1976 by The Vanguard Group, headed by John Bogle; it is now called the "Vanguard 500 Index Fund" and is one of the world's largest mutual funds, with more than $195 billion in assets as of January 31, 2015.

Fund industry growth continued into the 1980s and 1990s, as a result of three factors: a bull market for both stocks and bonds, new product introductions (including tax-exempt bond, sector, international and target date funds) and wider distribution of fund shares.

Among the new distribution channels were retirement plans. Mutual funds are now the preferred investment option in certain types of fast-growing retirement plans, specifically in 401(k) and other defined contribution plans and in individual retirement accounts (IRAs), all of which surged in popularity in the 1980s. Total mutual fund assets fell in 2008 as a result of the credit crisis of 2008.

In 2003, the mutual fund industry was involved in a scandal involving unequal treatment of fund shareholders. Some fund management companies allowed favored investors to engage in late trading, which is illegal, or market timing, which is a practice prohibited by fund policy. The scandal was initially discovered by former New York Attorney General Eliot Spitzer and led to a significant increase in regulation.

At the end of 2013, there were over 15,000 mutual funds in the United States with combined assets of $17 trillion, according to the Investment Company Institute (ICI), a trade association of U.S. investment companies. The ICI reports that worldwide mutual fund assets were $30 trillion on the same date.

Mutual funds play an important role in U.S. household finances; by the end of 2013, funds accounted for 22% of household financial assets. Their role in retirement planning is particularly significant. Roughly 60% of assets in 401(k) plans and individual retirement accounts were invested in mutual funds

Types of Mutual Funds

By Structure

There are three principal types of mutual funds in the United States: open-end funds, unit investment trusts (UITs); and closed-end funds. exchange-traded funds (ETFs) are open-end funds or unit investment trusts that trade on an exchange; they have gained in popularity recently. ETFs are one type of "exchange-traded product". While the term "mutual fund" may refer to all three types of registered investment companies, it is more commonly used to refer exclusively to the open-and closed-end funds.

Open-end funds

Open-end mutual funds must be willing to buy back their shares from their investors at the end of every business day at the net asset value (NAV) computed that day. Most open-end funds also sell shares to the public every day; these shares are also priced at NAV. A professional investment manager oversees the portfolio, buying and selling securities as appropriate. The total investment in the fund will vary based on share purchases, share redemptions and fluctuation in market valuation. There is no legal limit on the number of shares that can be issued.

Open-end funds are the most common type of mutual fund. At the end of 2013, there were 7,707 open-end mutual funds in the United States with combined assets of $15 trillion.

Closed-end funds

Closed-end funds generally issue shares to the public only once, when they are created through an initial public offering. Their shares are then listed for trading on a stock exchange. Investors who no longer wish to invest in the fund cannot sell their shares back to the fund (as they can with an open-end fund). Instead, they must sell their shares to another investor in the market; the price they receive may be significantly different from NAV. It may be at a "premium" to NAV (i.e., higher than NAV) or, more commonly, at a "discount" to NAV (i.e., lower than NAV). A professional investment manager oversees the portfolio, buying and selling securities as appropriate.

At the end of 2013, there were 599 closed-end funds in the United States with combined assets of $279 billion.

Unit investment trusts

Unit investment trusts (UITs) can only issue to the public once, when they are created. UITs generally have a limited life span, established at creation. Investors can redeem shares directly with the fund at any time (similar to an open-end fund) or wait to redeem them upon the trust's termination. Less commonly, they can sell their shares in the open market. Unit investment trusts do not have a professional investment manager; their portfolio of securities is established at the UIT's creation and does not change.

At the end of 2013, there were 5,552 UITs in the United States with combined assets of $87 billion.

Exchange-traded funds

A relatively recent innovation, exchange-traded funds (ETFs) are structured as open-end investment companies or UITs. ETFs are part of a larger category of investment vehicles known as "exchange-traded products" (ETPs), which, other than ETFs, may be structured as a partnership or grantor trust or may take the form of an exchange-traded note. Non-ETF exchange-traded products may be used to provide exposure to currencies and commodities.

ETFs combine characteristics of both closed-end funds and open-end funds. ETFs are traded throughout the day on a stock exchange. An arbitrage mechanism is used to keep the trading price close to net asset value of the ETF holdings.

Most ETFs are passively managed index funds, though actively managed ETFs are becoming more common.

ETFs have been gaining in popularity. As of December, there were over 1,294 ETFs in the United States with combined assets of $1.7 trillion.

By Investments Objective

Mutual funds are normally classified by their principal investments, as described in the prospectus and investment objective. The four main categories of funds are money market funds, bond or fixed income funds, stock or equity funds and hybrid funds. Within these categories, funds may be subclassified by investment objective, investment approach or specific focus. The SEC requires that mutual fund names be consistent with a fund's investments. For example, the "ABC New Jersey Tax-Exempt Bond Fund" would generally have to invest, under normal circumstances, at least 80% of its assets in bonds that are exempt from federal income tax, from the alternative minimum tax and from taxes in the state of New Jersey.

Bond, stock, and hybrid funds may be classified as either index (passively managed) funds or actively managed funds.

Money market funds

Money market funds invest in money market instruments, which are fixed income securities with a very short time to maturity and high credit quality. Investors often use money market funds as a substitute for bank savings accounts, though money market funds are not insured by the government, unlike bank savings accounts.

Money market funds strive to maintain a $1.00 per share net asset value, meaning that investors earn interest income from the fund but do not experience capital gains or losses. If a fund fails to maintain that $1.00 per share because its securities have declined in value, it is said to "break the buck". Only two money market funds have ever broken the buck—Community Banker's U.S. Government Money Market Fund in 1994 and the Reserve Primary Fund in 2008.

In 2014, the SEC approved significant changes in money market fund regulation. Beginning in October 2016, money market funds that are sold to institutional investors and that invest in non-government securities will no longer be allowed to maintain a stable $1.00 per share net asset value. Instead, these funds will be required to have a floating net asset value.

At the end of 2013, money market funds accounted for 18% of open-end fund assets.

Bond funds

Bond funds invest in fixed income or debt securities. Bond funds can be subclassified according to the specific types of bonds owned (such as high-yield or junk bonds, investment-grade corporate bonds, government bonds or municipal bonds) and by the maturity of the bonds held (short-, intermediate- or long-term). Bond funds may invest in primarily U.S. securities (domestic or U.S. funds), in both U.S. and foreign securities (global or world funds), or primarily foreign securities (international funds).

At the end of 2013, bond funds accounted for 22% of open-end fund assets.

Stock funds

Stock or equity funds invest in common stocks which represent an ownership share (or equity) in corporations. Stock funds may invest in primarily U.S. securities (domestic or U.S. funds), in both U.S. and foreign securities (global or world funds), or primarily foreign securities (international funds). They may focus on a specific industry or sector.

A stock fund may be subclassified along two dimensions: (1) market capitalization and (2) investment style (i.e., growth vs. blend/core vs. value). The two dimensions are often displayed in a grid known as a "style box".

Market capitalization ("cap") indicates the size of the companies in which a fund invests, based on the value of the company's stock. Each company's market capitalization equals the number of shares outstanding times the market price of the stock. Market capitalizations are typically divided into the following categories, with approximate market capitalizations in parentheses:

- Micro cap (below $300 million)
- Small cap (below $2 billion)
- Mid cap
- Large cap (at least $10 billion)

Funds can also be classified in these categories based on the market caps of the stocks that it holds.

Stock funds are also subclassified according to their investment style: growth, value, or blend (or core). Growth funds seek to invest in stocks of fast-growing companies. Value funds seek to invest in stocks that appear cheaply priced. Blend funds are not biased toward either growth or value.

At the end of 2013, stock funds accounted for 52% of the assets in all U.S. mutual funds.

Hybrid funds

Hybrid funds invest in both bonds and stocks or in convertible securities. Balanced funds, asset allocation funds, target date or target risk funds and lifecycle or lifestyle funds are all types of hybrid funds.

Hybrid funds may be structured as funds of funds, meaning that they invest by buying shares in other mutual funds that invest in securities. Many fund of funds invest in affiliated funds (meaning mutual funds managed by the same fund sponsor), although some invest in unaffiliated funds (i.e., managed by other fund sponsors) or some combination of the two.

At the end of 2013, hybrid funds accounted for 8% of the assets in all U.S. mutual funds.

Index (passively managed) versus actively managed

An index fund or passively managed fund seeks to match the performance of a market index, such as the S&P 500 index, while an actively managed fund seeks to outperform a relevant index through superior security selection.

Organization of a Mutual Fund

The **Organization of a Mutual Fund** is how the mutual funds are controlled. A number of entities are involved in the Organization of a Mutual Fund. This helps in the proper management of the mutual fund portfolio.

The Organization of a Mutual Fund contains entities such as

- **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.

Myths about Mutual Funds

1. Mutual Funds invest only in shares.

2. Mutual Funds are prone to very high risks/actively traded.

3. Mutual Funds are very new in the financial market.

4. Mutual Funds are not reliable and people rarely invest in them.

5. The good thing about Mutual Funds is that you don't have to pay attention to them.

Advantages of Mutual Funds

- **Diversification**. Mutual funds spread their holdings across a number of different investment vehicles, which reduces the effect any single security or class of securities will have on the overall portfolio. Because mutual funds can contain hundreds or thousands of securities, investors aren't likely to be fazed if one of the securities doesn't do well.

- **Expert Management**. Many investors lack the financial know-how to manage their own portfolio. However, non-index mutual funds are managed by professionals who dedicate their careers to helping investors receive the best risk-return trade-off according to their objectives.

- **Liquidity**. Mutual funds, unlike some of the individual investments they may hold, can be traded daily. Though not as liquid as stocks, which can be traded intraday, buy and sell orders are filled after market close.

- **Convenience**. If you were investing on your own, you would ideally spend time researching securities. You'd also have to purchase a huge range of securities to acquire holdings comparable to most mutual funds. Then, you'd have to monitor all those securities. Choosing a mutual fund is ideal for people who don't have the time to micromanage their portfolios.

- **Reinvestment of Income**. Another benefit of mutual funds is that they allow you to reinvest your dividends and interest in additional fund shares. In effect, this allows you to take advantage of the opportunity to grow your portfolio without paying regular transaction fees for purchasing additional mutual fund shares.

- **Range of Investment Options and Objectives**. There are funds for the highly aggressive investor, the risk averse, and the middle-of-the-road investor – for example, emerging markets funds, investment-grade bond funds, and balanced funds, respectively. There are also life cycle funds to ramp down risk as you near retirement. There are funds with a buy-and-hold philosophy, and others that are in and out of holdings almost daily. No matter your investing style, there's bound to be a perfect fund to match it.

- **Affordability**. For as little as $50 per month, you can own shares in Google (NASDAQ: GOOG), Berkshire Hathaway (NYSE: BRK.A), and a host of other expensive securities via mutual funds. At the time of this writing, a share of Berkshire Hathaway costs over $119,000 a share.

Disadvantages of Mutual Funds

Although mutual funds can be beneficial in many ways, they are not for everyone.

- **No Control Over Portfolio**. If you invest in a fund, you give up all control of your portfolio to the mutual fund money managers who run it.

- **Capital Gains**. Anytime you sell stock, you're taxed on your gains. However, in a mutual fund, you're taxed when the fund distributes gains it made from selling individual holdings – even if you haven't sold your shares. If the fund has high turnover, or sells holdings often, capital gains distributions could be an annual event. That is, unless you're investing via a Roth IRA, traditional IRA, or employer-sponsored retirement plan like the 401k.

- **Fees and Expenses**. Some mutual funds may assess a sales charge on all purchases, also known as a "load" – this is what it costs to get into the fund. Plus, all mutual funds charge annual expenses, which are conveniently expressed as an annual expense ratio – this is basically the cost of doing business. The expense ratio is expressed as a percentage, and is what you pay annually as a portion of your account value. The average for managed funds is around 1.5%. Alternatively, index funds charge much lower expenses (0.25% on average) because they are not actively managed. Since the expense ratio will eat directly into gains on an annual basis, closely compare expense ratios for different funds you're considering.

- **Over-diversification**. Although there are many benefits of diversification, there are pitfalls of being over-diversified. Think of it like a sliding scale: The more securities you hold, the less likely you are to feel their individual returns on your overall portfolio. What this means is that though risk will be reduced, so too will the potential for gains. This may be an understood trade-off with diversification, but too much diversification can negate the reason you want market exposure in the first place.

- **Cash Drag**. Mutual funds need to maintain assets in cash to satisfy investor redemptions and to maintain liquidity for purchases. However, investors still pay to have funds sitting in cash because annual expenses are assessed on all fund assets, regardless of whether they're invested or not. According to a study by William

O'Reilly, CFA and Michael Preisano, CFA, maintaining this liquidity costs investors 0.83% of their portfolio value on an annual basis.

Future of Mutual Funds In India-Facts on growth

Important aspects related to the future of mutual funds in India are -

- The growth rate was 100 % in 6 previous years.
- The saving rate in India is 23 %.
- There is a huge scope in the future for the expansion of the mutual funds industry.
- A number of foreign based assets management companies are venturing into Indian markets.
- The Securities Exchange Board of India has allowed the introduction of commodity mutual funds.
- The emphasis is being given on the effective corporate governance of Mutual Funds.
- The Mutual funds in India has the scope of penetrating into the rural and semi urban areas.
- Financial planners are introduced into the market, which would provide the people with better financial planning.

Conclusion

This paper documents the tendency of mutual fund managers to follow analyst recommendation revisions when they trade stocks, and the impact of these analyst revision-motivated mutual fund ³herds´ on stock prices. We find evidence that mutual fund herding impacts stock prices to a much greater degree during our sample period (1995 to 2006) than during prior-studied periods. Most importantly, we find that mutual fund herds form most prominently following aconsensus revision in analyst recommendations.

Positive consensus recommendation revisions result, most frequently,in a herd of funds buying a stock, while negative revisions result, most frequently, in a herd of funds selling. This relation remains robust after we control for stock characteristics and investment signals that influence both fund trading and analyst revisions and after using alternative measures of analyst revisions. In addition, mutual funds react more strongly to analyst information when it appears to be more credible.

Perhaps our most interesting result is that mutual funds appear to overreact when they follow analyst revisions² upgraded stocks heavily bought by herds tend to underperform their size, book-to-market, and momentum cohortsduring the following year, while downgraded stocks heavily sold outperform their cohorts. These findings suggest that funds initially overreact to analyst revisions.

Further evidence indicates that once we account for herding in response to analyst recommendation revisions, herding, in general, does not cause subsequent return reversals, nor does analyst revisions by themselves. Finally, we find that the selling of funds with greater career concerns (i.e., funds with poor past performance) plays a greater role in destabilizing stock prices, supporting the conjecture that analyst revision-induced herding is driven partly by non-information related incentives. Further investigation into other incentives that drive herding on analyst revisions is left to future research.

Reference

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