
3.8 COMMODITY MARKET

The vast geographical extent of India and her huge population is aptly complemented by the size of her market. The broadest classification of the **Indian Market** can be made in terms of the **commodity market** and the bond market. Here, we shall deal with the former in a little detail.

The **commodity market in India** comprises of all palpable markets that we come across in our daily lives. Such **markets** are social institutions that facilitate exchange of goods for money. The cost of goods is estimated in terms of domestic currency. **India Commodity Market** can be subdivided into the following two categories:

- **Wholesale Market**
- **Retail Market**

Let us now take a look at what the present scenario of each of the above markets is like.

The traditional **wholesale market in India** dealt with whole sellers who bought goods from the farmers and manufacturers and then sold them to the retailers after making a profit in the process. It was the retailers who finally sold the goods to the consumers. With the passage of time the importance of whole sellers began to fade out for the following reasons:

- The whole sellers in most situations, acted as mere parasites who did not add any value to the product but raised its price which was eventually faced by the consumers.
- The improvement in transport facilities made the retailers directly interact with the producers and hence the need for whole sellers was not felt.

In recent years, the extent of the **retail market** (both organized and unorganized) has evolved in leaps and bounds. In fact, the success stories of the **commodity market** of India in recent years has mainly centered around the growth generated by the **Retail Sector**. Almost every commodity under the sun both agricultural and industrial are now being provided at well distributed retail outlets throughout the country.

Moreover, the retail outlets belong to both the organized as well as the unorganized sector. The **unorganized retail outlets** of the yesteryears consist of small shop owners who are price takers where consumers face a highly competitive price structure. The **organized sector** on the other hand are owned by various business houses like Pantaloons, Reliance, Tata and others. Such markets are usually sell a wide range of articles both agricultural and manufactured, edible and inedible, perishable and durable. Modern marketing strategies and other techniques of sales promotion enable such markets to draw customers from every section of the society. However the growth of such markets has still centered around the urban areas primarily due to infrastructural limitations.

Considering the present growth rate, the total valuation of the **Indian Retail Market** is estimated to cross Rs. 10,000 billion by the year 2010. Demand for commodities is likely to become four times by 2010 than what it presently is.

Commodity Futures Markets in India

Agriculture sector in India has always been a major field of government intervention since long back. Government tries to protect the interests of the poor Indian farmers by procuring



crops at remunerative prices directly from the farmers without involving middlemen in between. This way Government maintains sufficient buffer stocks and at the same time provides the farmers safeguard against the fluctuating food crop prices. But government at the same time has restricted this traditional sector by fixing prices of crops at a particular level and also by imposing several other restrictions on export and import of agricultural commodities. All these restrictions prevented this sector to move out its traditional features. So according to many economists liberalization of this traditional agricultural sector could have been of great benefit to our economy. But questions will naturally come up about the maintenance of buffer stocks and provisions of remunerative prices to the farmers. In absence of government's intervention farmers will not be getting any prior information about the future markets of their products. Naturally a sudden price crash of food crops will have devastating effects on farmers. Here comes the significant role of futures market. If the buyers in the commodity market anticipate shortage of a particular crop in the coming season, future price of that crop will increase now and this will act as a signal to the farmers who will accordingly plan their seedling decisions for the next season. In the same way, an increase in future demand of food crops will be reflected in the today's price in futures market. In this way the system of futures market can be of great help to the Indian farmers preventing them from being directly exposed to the unexpected price changes all of a sudden. It also helps towards evolving a better cropping pattern in our country.

If the peasants are farming some crop now and are very much concerned that price will crash by the time the crop comes in, then if there is futures market, they will have the option to sell their products in it. Price in the future markets being fixed; by selling products in future markets they get rid of their worries about the about the unexpected price fall. This helps them to take the risk of innovations, by using new high yielding varieties of seeds, fertilizers and new techniques of cultivation. Futures Market will act as a smoothing agent between the present and future commodity market. If the price, which is going to prevail in future, is high compared to what is it now, then the arbitragers would like to buy the commodities now to sell those in future. The reverse process is also true. So the existence of a futures market is always good for any economy. It opens up a new opportunity to people to protect themselves from unexpected risks.

Bonus issues

A bonus issue is the issue of shares to existing shareholders in proportion to their existing holdings. It differs from a rights issue in that the shareholder is not obliged to make payment for the shares. Instead the company's capital reserves are used to effect payment, and for this reason a bonus issue is sometimes called a 'capitalisation issue'. Bonus issues are also sometimes called 'scrip issues'

The effect of a bonus issue is to increase the capitalisation of the company, so that the permanent capital available to it can more realistically reflect the assets employed by the company. As the number of shares in issue increases, the value of each share is reduced. This can make the shares more marketable. However, as the bonus shares are issued in proportion to existing holdings, the overall value of the shareholding is not affected. For example, if before the bonus issue the shareholder had 100 shares worth INR 10 each and after the bonus issue he has 200 shares worth INR 5 each, in both cases the value of the holding is INR 1,000

Issue of Bonus Shares by Public Sector Undertakings simplifying the Procedures.

2. The issue of Bonus Shares helps in bringing about a proper balance between paid up capital and accumulated reserves, elicit good public response to equity issues of the public enterprises and helps in improving the market image of the company.
3. Therefore, the Government has decided that the public enterprises, which are carrying substantial reserves in comparison to their paid up capital sold issue Bonus Shares to capitalize the reserves for which the following norms/conditions and criteria may be followed and fulfilled.

SEBI guidelines may be followed in deciding the correct proportion of reserves to be capitalized by issuing Bonus Shares. A copy of the bonus issue guidelines of SEBI is enclosed. For the purpose of determining the quantum of bonus issue, PSUs should be guided by the following factors:

- (i) Likely increase in capital base from fresh public issues by PSUs in the next two to three years (which will dilute the GOI's equity).
 - (ii) PSUs should prepare profit projections for the next three years on realistic basis as projected by them in their corporate plan and estimate their ability to service the enlarged equity after taking into account any fresh equity issue they expect to make for their expansion / diversification needs.
6. PSUs are at liberty to engage public / private sector merchant bankers to determine the quantum of bonus and provide advice on related matters. The mode of selection of merchant bankers and any fee payable for their services may be decided by PSU Boards.
 7. While recommending proposals for capitalizing reserves, PSUs should also consider the need for increasing their authorized capital to accommodate the release of bonus shares and any subsequent public issues and recommend increase in the capital where necessary.
 8. PSUs should ensure that after making the bonus there are enough reserves left which together with future plough-back of profit will be sufficiently large to inspire confidence and support from existing and potential shareholders. This is necessary to remain as an attractive scrip in the market.
 9. Each administrative Ministry may direct the enterprises under their control that PSUs having reserves in excess of three times their paid-up capital should immediately consider the scope for issuing bonus shares to GOI (and pro-rata to other existing shareholders if partial disinvestment had occurred so far). PSUs having large reserves may be allowed to make any public issue only after examining the scope for capitalizing a portion of reserves.
 10. Ministries / Departments should expeditiously examine and approve bonus issue proposals if the quantum of bonus and profit projections are found to be properly assessed and the PSUs certify that the proposals are in conformity with the SEBI guidelines.
 11. Bonus issue proposals need not be referred to Ministry of Finance (MoF) for approval unless there are special reasons to do so. Likewise proposals involving increase in authorized capital need not be referred to MoF. It has been clarified earlier that increase in authorized capital does not require Cabinet approval.



12. Ministries should keep the Department of Public Enterprises informed about bonus issue proposals and authorized capital increases approved by them.
13. The above conditions shall cut down the procedural delays in obtaining the approval for bonus shares besides enabling the PSUs to finalize public issue plans quickly and tap the capital market when conditions are favourable.
14. The Financial Advisers in the administrative Ministries shall keep a control over the fulfillment of various conditions / criteria as mentioned above before agreeing to the bonus issues.

Copy of Securities and Exchange Board of India (SEBI)'s guidelines Bonus Issue Guidelines.

SEBI believes that the Board of Directors of the companies wishing to make bonus issues will take into due consideration the relevant financial factors while deciding on bonus issues and observe the following guidelines.

Section M

- (i) These guidelines are applicable to existing listed companies who shall forward a certificate duly signed by the issuer and duly countersigned by its statutory auditor or by a company secretary in practice to the effect that the terms and conditions for issue of bonus shares as laid down in these guidelines, have been complied with.
- (ii) Issue of bonus shares after any public/right issue is subject to the condition that no bonus issue shall be made which will dilute the value or rights of the holders of debentures, convertible fully or partly.

In other words, no company shall, pending conversion of FCDs / PCDs, issue any shares by way of bonus unless similar benefit is extended to the holders of such FDCs / PCDs, through reservation of shares in proportion to such convertible part of FCDs or PCDs. The shares so reserved may be issued at the time of conversion(s) of such debentures on the same terms on which the bonus issues were made.
- (iii) The bonus issue is made out of free reserves built out of the genuine profits or share premium collected in cash only.
- (iv) Reserves created by revaluation of fixed assets are not capitalized.
- (v) The declaration of bonus issue, in lieu of dividend, is not made.
- (vi) The bonus issue is not made unless the partly-paid shares, if any existing, are made fully paid-up.
- (vii) The Company –
 1. has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption thereof and.
 2. has sufficient reason to believe that it has not defaulted in respect of the payment of statutory dues of the employees such as contribution to provident fund, gratuity bonus etc.



- (viii) A company, which announces bonus issue after the approval of the Board of Directors must implement the proposals within a period of six months from the date of such approval and shall not have the option of changing the decision.
- (ix) There should be a provision in the Articles of Association of the company for capitalization of reserves, etc. and if not, the company shall pass a Resolution at its General Body Meeting making provisions in the Articles of Association for capitalization.
- (x) Consequent to the issue of bonus shares if the subscribed and paid-up capital exceed the authorized capital, a Resolution shall be passed by company at its General Body Meeting for increasing the authorized capital.

Right issues

A rights issue is an issue of shares to existing shareholders in proportion to their existing shareholding. Rights issues are usually used when the company wishes to raise further capital from its existing shareholders

A shareholder who is provisionally allocated shares under a rights issue may sell his right to acquire the shares by renouncing their allotment in favour of another person.

SEBI's role in an issue: Any company making a public issue or a listed company making a rights issue of value of more than Rs 50 lakh is required to file a draft offer document with SEBI for its observations. The company can proceed further on the issue only after getting observations from SEBI. The validity period of SEBI's observation letter is three months only i.e. the company has to open its issue within three months period. SEBI does not recommend any issue nor does take any responsibility either for the financial soundness of any scheme or the project for which the issue is proposed for or for the correctness of the statements made or opinions expressed in the offer document. It is to be distinctly understood that submission of offer document to SEBI should not in any way be deemed or construed that the same has been cleared or approved by SEBI. The Lead manager certifies that the disclosures made in the offer document are generally adequate and are in conformity with SEBI guidelines for disclosures and investor protection in force for the time being. This requirement is to facilitate investors to take an informed decision for making investment in the proposed issue.

Dividend

Law relating to dividends - Recent developments

Dividend is the return that a shareholder gets from a company out of its profits, on his shareholding. The Companies Act has been amended by the Companies (Amendment) Act, 1999 and the Companies (Amendment) Act, 2000. The Government has permitted the issue of shares with differential rights. Dividend can be now paid through Electronic Clearing Services (ECS) by the banks. Foreign Exchange Management Act (FEMA), 1999 has been enacted to replace Foreign Exchange Regulation Act, 1973. Many investors hold shares in a electronic mode. On account of all these changes, a re-look at various aspects of the law relating to dividend has become necessary. In this comprehensive article, on the subject of dividend, the author goes through the entire gamut of the payment/distribution of dividend, including the aspect of tax deduction at source - Editor What is dividend The term 'dividend' refers to that part of the profits of a company which is distributed amongst its shareholders. It may, there-



fore, be defined as the return that a shareholder gets from the company, out of its profits, on his shareholding. According to the Institute of Chartered Accountants of India, dividend is a distribution to shareholders out of profits or reserves available for this purpose - See the Guidance Note on Terms used in Financial Statements. Definition of 'dividend' According to section 2(14A) of the Companies Act, 1956, the term 'dividend' includes any interim dividend. It is an inclusive and not an exhaustive definition. According to the generally accepted definition, 'dividend' means the profit of a company, which is not retained in the business and is distributed among the shareholders in proportion to the amount paid up on the shares held by them. The Supreme Court in CIT v. Giridharidas & Co. (P.) Ltd. AIR 1967 SC 795 has defined the term 'dividend' in the following manner : (i) As applied to a company which is a going concern, it ordinarily means the portion of the profits of the company, which is allocated to the holders of shares in the company. (ii) In the case of winding up, it means a division of the net realised assets among creditors and contributories according to their respective rights. Payment of dividend Every company (other than section 25 company) has an implied power to pay dividend to its members. However, the power to pay dividend is subject to the following two fundamental rules:

- (1) Dividend must not be paid out of capital.
- (2) Dividend should be paid out of profits. Company law provisions regarding dividend Section 205 of the Act provides as under

No dividend shall be declared or paid by a company for any financial year except : (1) Out of the profits for that year arrived at after providing for depreciation in accordance with sub-section (2) ; or

- (2) Out of the profits of the company for any previous year or years arrived at after providing depreciation in the prescribed manner and remaining undistributed or out of both;
- (3) Out of (a) and (b) above ;
- (4) Out of moneys provided by the Central or State Government for this purpose in pursuance of a guarantee given by that Government. Arrears of depreciation If the company has not provided for depreciation for any previous financial year or years, it shall, before declaring or paying dividend for any financial year, provide for such depreciation out of the profits of that year or any other previous year. Past losses to be set off If the company has suffered any loss in any financial year after December 28, 1960, then the amount of loss or the amount of depreciation, whichever is less, shall be set off against the profits of the company for that year for which dividend is declared or against the profits for any financial year or years. Transfer to reserve Before declaring any dividend, every company is required to transfer a percentage, not exceeding 10 per cent of the current profit to the reserves of the company as prescribed by the Companies (Transfer of Profits to Reserves) Rules, 1975. The percentage of profits required to be transferred to reserves is linked to the rate of dividend proposed for the year and is given hereunder:

Rate of dividend % of profit required to be

Transferred to reserves

Up to 10% Nil



Exceeding 10% but not exceeding 12.5% not less than 2.5% of the current profits

Exceeding 12.5% but not not less than 5% of the current

exceeding 15% profits

Exceeding 15% but not not less than 7.5% of the current exceeding 20% profits

Exceeding 20% not less than 10% of the current profits. The rules, however, do not prohibit the voluntary transfer by a company of a percentage higher than 10 per cent of its current profits to reserves for any financial year subject to certain conditions. Under rule 3, voluntary transfer by a company of a percentage higher than 10 per cent of its profits to reserves is allowed, provided that: (a) where a dividend is declared by a company in that financial year, a minimum distribution sufficient to maintain a rate of dividend equal to the average rates of dividend declared by it over the three years immediately preceding the financial year is ensured; (b) where bonus shares have been issued in the year in which the dividend is declared or in the three years immediately preceding the financial year, a company can transfer a higher percentage of profits to reserves, provided a minimum distribution of dividend to shareholders of an amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial year is maintained. However, maintenance of such minimum rate or quantum of dividend is not necessary if the net profits after tax in a financial year are lower by 20 per cent or more than the average profits after tax of the two immediately preceding financial years. Where no dividend is declared, the amount proposed to be transferred to its reserves from the current profits shall be lower than the average amount of the dividends to the shareholders declared by it over the three years immediately preceding the financial year. [The term 'reserves' referred to in the said rules means only free reserves]. A newly incorporated company is prohibited from transferring more than 10 per cent of its profits to its reserve - Circular No. 20/76(5)/10/76-CL-XIV and 1/1/76-CL-VI, dated July 26, 1976 issued by the Department of Company Affairs. Current profits The term 'current profits' for the purpose of transfer of specified percentage thereof to reserve means profits after statutory transfer to the Development Rebate Reserve and also after providing for arrears of depreciation, if any. The term 'dividend' referred to in the above-mentioned Rules is the dividend on equity shares and dividend payable on participating preference shares over and above the fixed rate of dividend on such preference shares. - Clarification issued by the Department of Company Affairs - Circular No. 8/76 (1/1/76-CL.V), dated May 18, 1976 read with 12/76 (1/1/-76-CL.V), dated June 10, 1976. Compliance with section 80A Section 80A of the Act provides that if a company has issued irredeemable preference shares, they must be redeemed within 5 years from June 15, 1988. Preference shares which are redeemable after 10 years should be redeemed as they fall due, but the period of redemption should not exceed 10 years. If a company is unable to redeem the preference shares as aforesaid, it should make a petition to the Company Law Board (CLB), which may permit their renewal under a 10 year scheme and then they shall be deemed to have been redeemed. If a company fails to comply with the provisions of section 80A, it shall not, so long as the failure continues, declare any dividend on its equity shares. Time limit for payment Where a dividend, whether interim or final, is declared, it should be deposited in a separate bank account within 5 days from the date of declaration. Dividend should be paid within 30 days from the date of declaration. Transfer to unpaid dividend account [Section 205A] The total amount of dividend remaining unpaid or unclaimed within 7 days from the date of expiry of 30 days from the date of declaration thereof



should be transferred to a separate bank account called 'Unpaid Dividend Account of . . . Company Ltd.'.

This requirement does not apply to the Government companies. The company should pay interest at the rate of 12 per cent per annum on any unpaid dividend amount, if the same is not transferred to the unclaimed dividend account within 37 days from the date of declaration of dividend. The interest so accruing shall be paid to the shareholders in proportion to the dividend amount remaining unpaid to them. Proportion in which dividend is payable Section 93 of the Act provides that a company may, if so authorised by its articles, pay dividend in proportion to the amount paid-up on each share where a larger amount is paid-up on some shares than on others. Companies which adopt the regulations contained in Table A of the Act can pay dividend in proportion to the amount paid-up on shares article 88 of Table A. However, if a company has excluded Table A and has its own articles, and its articles do not contain a regulation similar to article 88 of Table A, it has to pay dividend on the nominal amount of each share and not on the amount paid-up on the share - Oakbank Oil Co.'s case. Dividend on preference shares Preference shares are generally issued as cumulative, which means that the holders of such shares can claim the arrears of dividend on such shares. Arrears of dividend on preference shares can be paid only out of divisible profits. Preference shareholders are entitled to dividend before any dividend is paid on equity shares. Sometimes, preference shares are redeemed in the middle of the year. At the time of redemption, if the company has not declared dividend on preference shares, the company cannot pay dividend for the accounting year in which preference shares are redeemed. The dividend due at the time of redemption can be paid by the company only after the company declares dividend for the relevant year in its annual general meeting or the preference dividend due is declared by way of interim dividend. Sometimes preference shares are issued on non-cumulative basis. The non-cumulative preference shares give right to fixed percentage as dividend out of the profits of each year. If no profit is available in any year, the non-cumulative preference shareholders get nothing, nor can they claim unpaid fixed dividend in subsequent years. The preference shareholder cannot claim dividend as a matter of right, unless the dividend is declared by the company. Payment of dividend out of reserves Companies can declare dividend out of the accumulated profits earned in previous years and transferred to the reserves in case of inadequacy or absence of profits in any year in accordance with the Companies (Declaration of Dividends out of Reserves) Rules, 1975. The rules prescribe the following norms for declaration of dividend out of reserves, namely: (i) The rate of dividend is not to exceed the average of the rates of dividends declared in the preceding five years or 10% of the paid-up capital whichever is less. (ii) The amount drawn from the reserves shall not exceed one-tenth of the aggregate of its paid-up capital and free reserves. The amount so drawn is to be first utilized to set off the losses incurred in the financial year before any dividend is declared. (iii) The balance of reserves after such withdrawal shall not fall below 15% of its paid-up share capital. Payment of dividend from P & L account Since the conditions prescribed in the above-mentioned Rules are rigid, many companies follow the practice of keeping adequate surplus in the profit and loss account. Keeping such surplus in the profit and loss account will help the dividend to be paid at a higher rate permissible in the above-mentioned Rules as drawing the surplus from profit and loss account is not hit by these Rules. Declaration of dividend The Act does not specifically provide as to who should declare dividend. Section 217(1)(c) of the Act states that there shall be attached to every balance sheet laid before a company in general meeting a report by its

board of directors, with respect to the amount, if any, which it recommends should be paid by way of dividend. This section indicates that the board of directors is entitled to determine and recommend to the general meeting, the rate and quantum of dividend to be declared by the shareholders. If the directors do not recommend any dividend, the general meeting has no power to declare dividend. Section 173(1)(a) of the Act states that declaration of dividend is a routine business at the annual general meeting. Regulation 85 of Table A states that the company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the board. So, the general meeting at which dividend is declared has no power to increase the rate of dividend. However, the general meeting can reduce the rate of dividend. Though the right to declare dividend is given to the general meeting, the real control over dividend vests with the board of directors. Dividend to be paid to registered shareholder The dividend shall be paid only to the registered shareholder or to his order or to his bankers, or, in case a share warrant has been issued, to the bearer of such share warrant or to his bankers. In the case of joint holders, the dividend should be paid to the first joint holder. Payment of dividend to non-resident shareholders In term of the FEMA (Current Account Transactions) Rules, 2000, read with AD (MA Series) Circular No. 11, dated, May 16, 2000, an authorised dealer is empowered to remit payment of dividend by Indian Companies to non-resident shareholders and for this purpose, the Authorised dealers are empowered to devise their own documentation complying with section 10(5) of FEMA, 1999. Premium on issue of securities cannot be distributed as dividend According to section 205, dividend can be paid only out of profits or out of moneys provided by the Government for the purpose. Premium on issue of securities cannot be distributed legally, as dividend because, according to section 78(2), it can be applied only for the following four purposes, namely:

- (i) for issuing bonus shares;
- (ii) for writing off the preliminary expenses of the company;
- (iii) for writing off the expenses of or the commission paid or discount allowed on, any issue of shares or debentures of the company;
- (iv) for providing for the premium payable on the redemption of any redeemable preference shares or of any debentures of the company. Recent developments The Department of Company Affairs has issued a notification stating that the payment of dividend to the shareholders involving the fraction of 50 paise and above be rounded off to the rupee and the fraction of less than 50 paise may be ignored - Notification No. GSR No. 598(E), dated July 28, 1994. Whenever a company issues dividend warrant, banks insist that the dividend warrants should be printed with MICR coding with a view to facilitating clearance of the dividend warrants in the RBI/Bankers' clearing house. Before issuing dividend warrants, banks should get Reserve Bank's clearance for the quality of paper used for printing dividend warrants and the quality of printing. This clearance is given by the National Clearing Cell in the Reserve Bank. The Budget for 2002-2003 has proposed that tax should be deducted at source on dividends paid as provided in section 194 of the Income-tax Act. In this connection, the Department of Company Affairs has issued general Circular No. 17 of 2002 vide F. No. 17/36/2002-CL-V, dated July 5, 2002. The Circular is reproduced below: "Section 205(3) of the Companies Act, 1956 ('the Act') provides for payment of dividend except in cash and section 205(5)(b) of the Act further provides



that the dividend payable in cash may be paid either by cheque or warrant. Subsequent to the amendment to section 10(33) of the Income-tax Act, 1961, dividend would be taxable in the hands of the recipient in respect of dividend income and this would, in the opinion of the Department of Revenue, involve huge amount of paper work as persons responsible for paying the income would be required to deduct tax at source from the amount of dividend paid and issue of TDS certificate. The Department of Revenue in order to reduce the additional paper work involved in the above method had suggested that the dividend warrant or intimation sent to the shareholders by company may be modified to contain the TDS also. Accordingly, in consultation with the Department of Revenue, it is hereby, clarified that henceforth, companies may adopt a format for dividend warrants to include information on TDS as under:

Ledger folio No. of equity shares Warrant No Gross dividend (Rs) Rate of tax Tax deducted (Rs) Net amt. payable(Rs) Certified that a sum of Rs. (in words).....has been deducted at source and paid to the credit of the Central Government.

Place.....

Signature of person responsible

for deduction of tax

Date..... Full Name.....Designation.....

The above format of TDS may be printed on the reverse side of the warrant duly signed by persons responsible for deduction of tax. You are requested to kindly bring to the notice of your constituents about the circular and request them to adopt the same. Wherever demat and transfer of dividend by electronic mode is used, the companies may, however, issue TDS in the same format. While dividend is paid by cash or cheque, companies may issue TDS certificate in the above format along with dividend intimation."Equity shares with differential rights The Companies (Amendment) Act, 2000 has introduced a new type of equity shares which may carry differential rights as to voting, dividend, etc. Issue of such shares is governed by the Companies (Issue of Share Capital with Differential Rights), Rules, 2001. It is now possible to issue equity shares carrying a higher rate of dividend, say 1 per cent or 2 per cent more than the dividend on ordinary equity shares. If such shares are issued by the company, the dividend payable on those shares should be separately calculated as per the terms of issue of such shares. Dividend on dematerialised shares Many companies have entered into agreement with National Securities Depository Ltd. (NSDL) and Central Depository Services (India) Ltd. (CDSL) for converting physical shares into dematerialised shares (that is, shares are converted into electronic form). The shares held in electronic form are transferred by the depository. Companies collect the list of members holding shares in the depository and pay them the dividend. Stock exchange requirements In case of listed companies, the following clauses of Listing Agreement have to be complied with. (i) At least 42 days' notice in advance of the closure of the Register of Members or Record Date is to be given to the Stock Exchanges where the company's shares are listed. This notice should be sent to other recognised Stock Exchanges in India. [Clause 16 of the Listing Agreement] 30 days advance notice should be given to the Depositories if the company's shares are dematerialised, about Closure of Register of Members.(ii) Date of Board Meeting at which dividend is declared / recommended is due to be considered [Clause (19) of Standard Listing Agreement] is to be notified 7 days in advance to



Stock Exchange where the shares of the company are listed. (iii) The dividend will be recommended / declared at least 5 days before commencement of closure of Transfer books or record date fixed for the purpose [Clause (19) of Listing Agreement].(iv) The Stock Exchange on which shares are listed should be intimated immediately by letter, (telegram, fax, e-mail if the meeting is held outside the city) the Board meeting has been held to consider or decide the dividend to be declared (Clause 20 of Standard Listing Agreement), about all the dividend recommended or declared.(v) The Stock Exchange should be informed at least 21 days in advance of the date on and from which the dividend on shares shall be payable and issue simultaneously the dividend warrants which should be collectable at par with collection charges, if any, being borne by the company, in any bank in the country at the centres other than the centres agreed to between the company and the exchange [clause (21) of Standard Listing Agreement]. Revocation of declared dividend As stated earlier, a dividend including interim dividend once declared becomes a debt. So, it cannot be revoked, except with the consent of the shareholders. Dividend can be paid through Electronic Clearing Services (ECS)The shareholders have complained in the past about loss of dividend warrants sent by post due to pilferage in transit or undue delay in receipt of dividend warrants through post. According to section 205(5)(b), a company may remit dividend in cash or by cheque or by warrant. It is, however, well-known that the amount of dividend can also be transmitted electronically to shareholders after obtaining their consent in this regard and asking them to nominate a specific bank account number to which the dividend due to them should be remitted. The Central Vigilance Commission has issued an order dated November 27, 1998 directing that the banks may switch over to remittance of dividends by computerised means as it will help to improve the vigilance administration. The Central Vigilance Commissioner has also requested the Department of Company Affairs that in the interest of greater transparency, listed companies in India may be directed that they should go in for computerised cash transaction so far as payments of dividend, interest, refund, etc., are concerned. Consequently, the Department of Company Affairs, has recently advised listed companies to encourage their shareholders to send their authorisation to remit dividend to their designated bank account by means of electronic transfer as this will result in avoiding delay in remittance of dividend, etc., SEBI has also asked the listed companies to use Electronic Clearing Service facility for payment of dividend wherever such facility is available. [SEBI Circular DCC/FITT/CIR 3/2001, dated October 15, 2001]. ECS facility is extended by Reserve Bank of India (RBI) in 15 Centres, State Bank of India (SBI) in 30 Centres

State Bank of Indore : Indore. Procedure for transfer of unpaid or unclaimed dividend to the Investor Education Protection Fund Sub-section (5) of section 205A provides that, if any, money transferred to an 'unpaid dividend account' in a scheduled bank remains unpaid or unclaimed for a period of 7 years from the date of such transfer, the company should transfer the same to the Investor Education and Protection Fund established under section 205C(1). For this purpose the following procedure should be followed by the company: Prepare the statement in the prescribed form stating all sums to be transferred from the unpaid dividend account with the bank to the fund, the nature of the sum, the names and last known addresses of the persons entitled to receive the same, the amount to which each person is entitled and nature of his claim thereto and other particulars prescribed. Get a DD from the bank where the company maintains its unpaid dividend account in favour of Punjab National Bank and remit the amount with any of the specified branch of Punjab National Bank by presenting the challan in triplicate in the prescribed form. The Head of Account in which the amount is to be remitted is:



Major Head 0075 - Miscellaneous General Services Minor Head 104 - Unclaimed and unpaid dividends, deposits and debentures, etc., of investors in companies. The remittance should be made within 30 days from the date of expiry of 7 years - Rule 3 of Investor Education and Protection Fund [Awareness and Protection of Investors] Rules, 2001. The bank will return 2 copies of the challan to the company as token of having received the amount. The company should file one copy of the challan with the Registrar of Companies and file with him a statement in Form-I duly certified by a Chartered Accountant or a Company Secretary or a Cost Accountant or the Statutory Auditors. Deduction of tax at source on dividend General Provision. - According to section 194 of the Income-tax Act, a company has to ensure that income-tax is deducted at source from the dividends payable to the shareholders at the appropriate rate as contained in the Annual Finance Act. The tax deducted at source should be rounded off to the nearest rupee as provided in section 288B of the Income-tax Act. The Government has clarified that rounding off is to be done in relation to the total amount of the tax finally payable and not in relation to the amount under the various heads, namely, income-tax, surcharge, etc., (Letter F.N.O. F. No. 12/40/66-IT(B) dated January 25, 1967). Exemptions. - Tax need not be deducted at source on dividend, if the company which pays dividend, is a company in which public are substantially interested and the person who is entitled to the dividend is a resident individual and the dividend does not exceed Rs. 2,500 and it is paid by an account-payee cheque (in the case of a closely held company, tax is to be deducted at source even if the dividend is below Rs. 2,500). Tax at source should not be deducted from the dividend payable to notified mutual funds notified under clause (23D) of section 10 of the Income-tax Act. No deduction of income-tax is to be made on the dividend payable to the Unit Trust of India in view of section 32(2)(a) of the Unit Trust of India Act, 1963. Tax should not be deducted on dividend paid to the General Insurance Corporation of India and its four wholly owned subsidiaries, viz., The National Insurance Company Limited, The New India Assurance Company Limited, The Oriental Insurance Company Limited and the United India Insurance Company Limited in view of section 35A of General Insurance (Nationalisation) Act, 1972. Where the shareholder has filed a declaration in Form No. 15G in duplicate to the company, tax should not be deducted at source from the dividend. If the shareholder has made an application in Form No. 13 to the ITO and the ITO has granted a certificate in Form No. 15 to the company authorising the company to pay dividend without deducting income-tax at source, the company need not deduct income-tax from the dividend payable to the shareholder concerned. Double taxation avoidance agreements and TDS. - Foreign income of a person generally becomes liable to tax in two countries - the country in which the income is earned and the country in which the person is resident. Double taxation of such income is avoided by means of Double Taxation Avoidance Agreement entered into by the Government of India with the Government of other countries under section 90 of the Income-tax Act. The Government of India has entered into agreement for avoidance of double taxation with about 57 countries. In such cases, the rate of tax on dividend income is specified in the agreement. If the rate of tax specified is less than the rate of tax to be deducted at source on the dividend income, the tax to be deducted at source on the dividend is the lower rate. This aspect has to be taken into account while deducting income-tax at source on dividend payable by companies to non-residents. TDS account number. - Every company which pays dividend should have obtained a TDS account number from the assessing authority. If the company has not got the TDS account

number, it should apply for allotment of TDS account number to the assessing authority (TDS circle) in Form No. 49B in duplicate within one month from the end of the month in which tax on dividends was deducted. The TDS account number (TAN) should be quoted on all TDS challans, certificates and returns. Some other obligations of company regarding TDS. - The tax deducted at source should be remitted to the Government within 7 days from the date of payment of dividend and the company has to issue a tax deduction certificate in Form No. 16A to the shareholders concerned. The tax deduction certificate should be issued to the shareholder within one month from the end of the month in which dividend warrant was issued [Rules 31(3) of Income-tax Rules, 1962]. The company has to file an annual return in Form No. 26 with the income-tax department on or before 30th April. Further, the company has to furnish an annual return in Form No. 27B on or before 30th April of each year, furnishing details of dividend paid without deduction of tax. The company has to file a copy of the declaration filed by the shareholders in Form No. 15G with the Commissioner, who has jurisdiction over the Assessing Officer on or before 7 days of the month next following the month in which the declaration is furnished to the company. Case of NRI's. - In case a shareholder entitled to dividend is a non-resident Indian, tax at the appropriate rate has to be deducted at source from the dividend even if the dividend is below Rs. 2,500. However, if the non-resident shareholder has made an application to the ITO in Form No. 13 for grant of a certificate under section 197 for non-deduction of tax at source for dividends and the ITO has granted a certificate in Form No. 15 to the company authorising the company to pay dividend without the deduction of tax, the company should not deduct tax on dividends to the non-resident shareholder concerned. In the case of investments made by the non-residents in the shares issued in accordance with the Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993, income-tax is to be deducted at source at the rate of 10 per cent on dividends as provided in section 115AC of the Income-tax Act. Wherever dividend is paid to non-residents, the company has to file Form No. 27 to the Assessing Officer having jurisdiction in terms of rule 36A of Income-tax Rules, 1962, within 14 days after expiry of two months from the date of payment of dividend. Case of HUF. - Many HUF's are now-a-days investing in the shares of companies and such shares are held in the name of the Karta of the family. Wherever the shares are held by the Karta, the exemption provided under section 194, for payment of dividend up to Rs. 2,500 without deduction of tax at source cannot be applied, as a HUF is a distinct entity for income-tax purpose. The exemption for payment of dividend up to Rs. 2,500 without tax deduction at source applies only to resident individuals and not to HUF. Hence, the company has to deduct income-tax at the rates applicable to HUF at the time of paying dividend to the Karta of the HUF.

BUYBACK TO REVIVE CAPITAL MARKET

The Government promulgated the much awaited Ordinance on October 31 allowing companies to buyback their shares. The measure is generally welcomed by Industry as it is seen as a major step to revive the sagging capital market, which has been bearish for quite some time now. The Ordinance followed the Prime Minister's announcement in the Annual General Meeting of the Federation of Indian Chambers of Commerce and Industry (FICCI) on October 24 that the Government would come out with a package of economic reforms to enable the capital market look up.



Salient Features

One of the salient features of the Ordinance is to allow companies to buyback their own shares up to 25 per cent of paid-up capital and free reserves. It also gives full freedom to make inter-corporate investments and loans to other corporate bodies. But this could be only up to 60 per cent of paid-up share capital and free-reserves with the approval of board of directors. Beyond this limit, the companies will have to pass a special resolution in the general meeting.

These two major provisions along with permission to issue sweat equity by companies in the Ordinance which amends the 1956 Companies Act for this purpose, is seen as a major liberalisation effort to enable the country move towards international standards in this regard.

The Ordinance also provides for nomination facility to the holders of shares/debentures/deposits, setting up of investor education and protection fund and declaring Infrastructure Development as a Public Financial Institution. There are also provisions for mandatory compliance of Accounting Standards by companies.

Regulatory Mechanism

Some analysts point out that the ordinance could make the capital market volatile unless proper surveillance system is put in place as in developed countries to take timely action in regulating the market. The Ordinance has set a punishment of a two-year imprisonment or a fine of Rs.50,000 in the event of a company violating the rules. But it does not mention on violation of Securities and Exchange Board of India (SEBI) guidelines. SEBI, the main regulator of the Capital Market, is yet to fine tune its guidelines as it does not want to do anything in hurry without making a proper study of prevalent practices elsewhere.

The amendments in Companies Act should be followed by a proper regulatory mechanism and surveillance system. This is only a first step to free the companies from the shackles of bureaucratic controls so as to move towards international standards in this area. The amendments to the 1956 Companies Act through this Ordinance are some immediate Government initiatives to revive the sagging capital markets.

Comprehensive Companies Bill

In fact, the Government, more so SEBI, is aware of certain pitfalls and is seized of the matter. Most of these concerns are addressed in the Comprehensive Companies Bill 1997 which is pending before Parliament. The Bill, which has been referred to a Parliamentary Standing Committee, is to replace the outmoded 1956 Companies Act. It has several features to facilitate not only further growth of the capital market but also in an orderly manner as in developed countries.

There are indications that the Bill may come up in the winter session of Parliament scheduled to begin on November 30. By then SEBI would have come to terms with the details of the Ordinance and put in place broad guidelines to ensure orderly implementation of the provisions of the Ordinance. The Dhanuka Panel has made some suggestions based on certain models adopted in developed markets.

Buyback Conditions

As it is, the Ordinance has provided certain safeguards to ensure that buyback and intercorporate investments are not misused by companies. They include: buyback of shares will not be allowed



if the companies have defaulted in repayment of deposits, redemption of debentures / preferences shares and repayment to financial institutions. Also buyback of shares can be done only out of company's free reserves, securities premium account or proceeds of any earlier issue specifically made for buyback purposes.

Thirdly, buyback is permitted only if the Article of Association of the companies authorise the same and that the process has to be completed within 12 months and shares bought back have to be extinguished and physically destroyed within seven days. Also the companies will have to comply with SEBI regulations and guidelines. The Ordinance also stipulates transparency in the buyback operations.

In the case of Inter-Corporate investments and loans, the Companies will not be allowed to give loan to any corporate body at an interest rate lower than the prevailing bank rate.

Sweat Equity

On the issue of Sweat Equity, the Ordinance makes it clear that it would be subject to SEBI regulations and all limitations, restrictions and provisions relating to equity shares will be applicable to Sweat Equity as well. It also defines Sweat Equity as those shares allotted either on discount or for consideration other than cash for providing know-how and intellectual rights for value addition.

Once Companies start resorting to buyback and intercorporate investments, it would be clear if capital markets behave in an orderly manner and course correction if any can be taken at the time of the passage of the Comprehensive Companies Bill, 1997 in Parliament. **(PIB)**

SEBI Guidelines on Buy Back of Shares

The provisions regulating buy back of shares are contained in Section 77A, 77AA and 77B of the Companies Act, 1956. These were inserted by the Companies (Amendment) Act, 1999. The Securities and Exchange Board of India (SEBI) framed the SEBI (Buy Back of Securities) Regulations, 1999 and the Department of Company Affairs framed the Private Limited Company and Unlisted Public company (Buy Back of Securities) rules, 1999 pursuant to Section 77A(2)(f) and (g) respectively.

Objectives of Buy Back: Shares may be bought back by the company on account of one or more of the following reasons

- i. To increase promoters holding
- ii. Increase earning per share
- iii. Rationalise the capital structure by writing off capital not represented by available assets.
- iv. Support share value
- v. To thwart takeover bid \
- vi. To pay surplus cash not required by business

In fact the best strategy to maintain the share price in a bear run is to buy back the shares from the open market at a premium over the prevailing market price.

Resources of Buy Back

A Company can purchase its own shares from



- (i) free reserves; Where a company purchases its own shares out of free reserves, then a sum equal to the nominal value of the share so purchased shall be transferred to the capital redemption reserve and details of such transfer shall be disclosed in the balance-sheet or
- (ii) securities premium account; or
- (iii) proceeds of any shares or other specified securities. A Company cannot buyback its shares or other specified securities out of the proceeds of an earlier issue of the same kind of shares or specified securities.

Conditions of Buy Back

- (a) The buy-back is authorised by the Articles of association of the Company;
- (b) A special resolution has been passed in the general meeting of the company authorising the buy-back. In the case of a listed company, this approval is required by means of a postal ballot. Also, the shares for buy back should be free from lock in period / non transferability. The buy back can be made by a Board resolution If the quantity of buyback is or less than ten percent of the paid up capital and free reserves;
- (c) The buy-back is of less than twenty-five per cent of the total paid-up capital and free reserves of the company and that the buy-back of equity shares in any financial year shall not exceed twenty-five per cent of its total paid-up equity capital in that financial year;
- (d) The ratio of the debt owed by the company is not more than twice the capital and its free reserves after such buy-back;
- (e) There has been no default in any of the following
 - i. in repayment of deposit or interest payable thereon,
 - ii. redemption of debentures, or preference shares or
 - iii. payment of dividend, if declared, to all shareholders within the stipulated time of 30 days from the date of declaration of dividend or
 - iv. repayment of any term loan or interest payable thereon to any financial institution or bank;
- (f) There has been no default in complying with the provisions of filing of Annual Return, Payment of Dividend, and form and contents of Annual Accounts;
- (g) All the shares or other specified securities for buy-back are fully paid-up;
- (h) The buy-back of the shares or other specified securities listed on any recognised stock exchange shall be in accordance with the regulations made by the Securities and Exchange Board of India in this behalf; and
- (i) The buy-back in respect of shares or other specified securities of private and closely held companies is in accordance with the guidelines as may be prescribed.

Disclosures in the explanatory statement

The notice of the meeting at which special resolution is proposed to be passed shall be accompanied by an explanatory statement stating -

- (a) a full and complete disclosure of all material facts;
- (b) the necessity for the buy-back;
- (c) the class of security intended to be purchased under the buy-back;
- (d) the amount to be invested under the buy-back; and
- (e) the time-limit for completion of buy-back

Sources from where the shares will be purchased

The securities can be bought back from

- (a) existing security-holders on a proportionate basis; Buyback of shares may be made by a tender offer through a letter of offer from the holders of shares of the company or
- (b) the open market through
 - (i) book building process;
 - (ii) stock exchanges or
- (c) odd lots, that is to say, where the lot of securities of a public company, whose shares are listed on a recognized stock exchange, is smaller than such marketable lot, as may be specified by the stock exchange; or
- (d) purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

Filing of Declaration of solvency

After the passing of resolution but before making buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in form 4A. The declaration must be verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any: No declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognized stock exchange.

Register of securities bought back

After completion of buyback, a company shall maintain a register of the securities/shares so bought and enter therein the following particulars

- a. the consideration paid for the securities bought-back,
- b. the date of cancellation of securities,
- c. the date of extinguishing and physically destroying of securities and
- d. such other particulars as may be prescribed

Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within seven days of the last date of completion of buy-back.

**Issue of further shares after Buy back**

Every buy-back shall be completed within twelve months from the date of passing the special resolution or Board resolution as the case may be. A company which has bought back any security cannot make any issue of the same kind of securities in any manner whether by way of public issue, rights issue up to six months from the date of completion of buy back.

Filing of return with the Regulator

A Company shall, after the completion of the buy-back file with the Registrar and the Securities and Exchange Board of India, a return in form 4 C containing such particulars relating to the buy-back within thirty days of such completion. No return shall be filed with the Securities and Exchange Board of India by an unlisted company.

Prohibition of Buy Back

A company shall not directly or indirectly purchase its own shares or other specified securities -

- (a) through any subsidiary company including its own subsidiary companies; or
- (b) through any investment company or group of investment companies; or

Procedure for buy back

- a. Where a company proposes to buy back its shares, it shall, after passing of the special / Board resolution make a public announcement at least one English National Daily, one Hindi National daily and Regional Language Daily at the place where the registered office of the company is situated.
- b. The public announcement shall specify a date, which shall be “specified date” for the purpose of determining the names of shareholders to whom the letter of offer has to be sent.
- c. A public notice shall be given containing disclosures as specified in Schedule I of the SEBI regulations.
- d. A draft letter of offer shall be filed with SEBI through a merchant Banker. The letter of offer shall then be dispatched to the members of the company.
- e. A copy of the Board resolution authorising the buy back shall be filed with the SEBI and stock exchanges.
- f. The date of opening of the offer shall not be earlier than seven days or later than 30 days after the specified date
- g. The buy back offer shall remain open for a period of not less than 15 days and not more than 30 days.h. A company opting for buy back through the public offer or tender offer shall open an escrow Account.

Penalty

If a company makes default in complying with the provisions the company or any officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years, or with fine which may extend to fifty thousand rupees, or with both. The offences are, of course compoundable under Section 621A of the Companies Act,1956

Key Words

- Debt Market
- Wholesale Debt Market Segment
- Trading, Clearing and Settlement in WDS
- Retail Debt Segment (REDS) Retail Trading in G-Secs
- Debentures
- *Bearer Debentures*
- *Registered Debentures*
- *Redeemable Debentures*
- *Debentures Issued as Collateral Security for a Loan*
- *Naked Debentures*
- *Secured Debentures*
- Mezzanine Finance
- Hybrid Debt Instruments
- Zero Interest Bond
- Equity Warrants with NCDs
- Secured Premium Notes
- Deep Discount Bond
- Debt for Equity Swap
- Junk Bonds
- Step-up and step-down Debentures
- Callable Bond
- Option Tender Bonds
- Guaranteed Debentures
- Subordinated Debentures
- Floating Rate Bonds
- Bonus shares
- Right Shares
- Dividend
- Share Buy Back

**Self Study Question**

1. Study on the Indian Debt market
2. What are the guidelines given by SEBI on Buy back of shares?
3. Write different instruments traded in debt market
4. Explain in detail wholesale and retail debt market
5. Write on SEBI regulation on Dividend , rights issue and bonus issue
6. Write a note on the Bonus issues and Right issues

3.9 PORTFOLIO MANAGEMENT***Old School Investing***

We have been conditioned to think of market timing, stock selection, and manager performance as the keys to success. Because these beliefs are deeply ingrained, even superior investment strategies like Strategic Global Asset Allocation take a little getting used to.

What I'm advocating is so different from public expectations that sometimes people look at me as if I'm not quite right or a few bricks short of a full load. For instance:

- As an investment advisor, I'm expected to have an opinion on where the market is going. Well, I have an opinion, but it's no more likely to come true than yours or your dog's. People are offended and disappointed when I tell them that.

Thanks to the media, we are exposed daily to countless "experts" who are worried about the market. Their indicators and forecasts point to a possible "correction." They are prepared to retreat to the "safety" of cash. This allows them to look responsible, conservative, and caring. By pandering to the public's fear, they hope thousands of anguished investors will decide to trust them with their money. On the other hand, advisors who insist on remaining fully invested at all times appear wild and crazy

- Advisors are supposed to beat somebody or something. Often the first question people will ask is: "What kind of numbers have you achieved this year?" Those numbers become the chief yardstick to determine if the advisor is good or bad.
- I'm still waiting for the first investor to ask: "What's the best long-term allocation?" Or, "How much risk do I need to take to meet my goals?"

Without tools to evaluate risk or choose between alternative strategies, investors are left with just one number to compare performance. By default, year-to-date or last year's performance figures are the only criteria for measurement. If those figures alone determined a successful investment plan, we could all buy one copy of *Money Magazine* each year, pick the single, top-performing mutual fund, and go sailing. Unfortunately, the *Money Magazine* approach is often the worst way to form a strategy.

PHASES OF PORTFOLIO MANAGEMENT

1. Specification of investment objectives and constraints
2. Choice of asset mix

3. Formulation of portfolio strategy
4. Selection of securities
5. Portfolio execution
6. Portfolio revision
7. Portfolio evaluation

Turning Your Goals into a Strategy

Every strategy has certain performance implications. The word *strategy* implies a conscious effort to achieve stated goals. Their concern is to at least meet their minimum acceptable return levels without taking excessive risk. They want a comfortable and stress-free retirement.

The asset-allocation design will determine results in both short- and long-term periods. What's more, both risk and returns will be driven far more by asset allocation than stock selection or market timing.

We could have looked at the 20-year, asset-class returns and seen that foreign, small-company stocks produced the highest return. But putting all the Joneses' money in foreign, small-company stocks will not produce a comfortable and stress-free retirement. Any asset class can and will have extended periods of serious under-performance from its long-term trend. And foreign, small-company stocks can and do have wild swings in short-term performance.

SPECIFICATION OF INVESTMENT OBJECTIVES

The commonly stated investment goals are : income, growth, and stability Since income and growth represent two ways by which return is generated and stability implies containment of risk, investment objectives may be expressed more succinctly in terms of return and risk.

Constraints

You might be familiar with the risk-reward concept, which states that the higher the **risk** of a particular investment, the higher the possible return. But, many investors do not understand how to determine the level of risk their individual portfolios should bear. This article provides a general framework that any investor can use to assess his or her personal level of risk and how this level relates to different investments.

Risk-Reward Concept

This is a general concept underlying anything by which a return can be expected. Anytime you invest money into something there is a risk, whether large or small, that you might not get your money back. In turn, you expect a return, which compensates you for bearing this risk. In theory the higher the risk, the more you should receive for holding the investment, and the lower the risk, the less you should receive.

Asset Allocation / ASSET MIX

It's no secret that throughout history common stock has outperformed most financial instruments. If an investor plans to have an investment for a long period of time, his or her portfolio should be comprised mostly of stocks. Investors who don't have this kind of time should diversify their portfolios by including investments other than stocks. For this reason, the con-



cept of asset allocation was developed. Asset allocation is an investment portfolio technique that aims to balance risk and create diversification by dividing assets among major categories such as bonds, stocks, real estate, and cash. Each asset class has different levels of return and risk, so each will behave differently over time. At the same time that one asset is increasing in value, another may be decreasing or not increasing as much.

The underlying principle of asset allocation is that the older a person gets, the less risk he or she should take on. After you retire, you may have to depend on your savings as your only source of income. It follows that you should invest more conservatively because asset preservation is crucial at this time in life.

Determining the proper mix of investments in your portfolio is extremely important. Deciding what percentage of your portfolio you should put into stocks, mutual funds, and low risk instruments like bonds and treasuries isn't simple, particularly for those reaching retirement age. Imagine saving for 30 or more years only to see the stock market decline in the years before your retirement.

Portfolio Strategies

Passive

One of the most profound ideas affecting the investment decision process, and indeed all of finance, is the idea that the securities markets, particularly the equity markets, are efficient. In an efficient market, the prices of securities do not depart for any length of time from the justified economic values that investors calculate for them. Economic values for securities are determined by investor expectations about earnings, risks, and so on, as investors grapple with the uncertain future. If the market price of a security does depart from its estimated economic value, investors act to bring the two values together. Thus, as new information arrives in an efficient marketplace, causing a revision in the estimated economic value of a security, its price adjusts to this information quickly and, on balance, correctly. In other words, securities are efficiently priced on a continuous basis.

Passive strategies do not seek to outperform the market but simply to do as well as the market. The emphasis is on minimizing transaction costs and time spent in managing the portfolio because any expected benefits from active trading or analysis are likely to be less than the costs. Passive investors act as if the market is efficient and accept the consensus estimates of return and risk, accepting current market price as the best estimate of a security's value.

Active

Investors who do not accept the EMH, or have serious doubts, pursue active investment strategies, believing that they can identify undervalued securities and that lags exist in the market's adjustment of these securities' prices to new (better) information. These investors generate more search costs (both in time and money) and more transaction costs, but they believe that the marginal benefit outweighs the marginal costs incurred.

Most investment techniques involve an active approach to investing. In the area of common stocks the use of valuation models to value and select stocks indicates that investors are analyzing and valuing stocks in an attempt to improve their performance relative to some benchmark such as a market index. They assume or expect the benefits to be greater than the costs.



Pursuit of an active strategy assumes that investors possess some advantage relative to other market participants. Such advantages could include superior analytical or judgment skills, superior information, or the ability or willingness to do what other investors, particularly institutions, are unable to do. For example, many large institutional investors cannot take positions in very small companies, leaving this field for individual investors. Furthermore, individuals are not required to own diversified portfolios and are typically not prohibited from short sales or margin trading as are some institutions.

Most investors still favor an active approach to common stock selection and management, despite the accumulating evidence from efficient market studies and the published performance results of institutional investors. The reason for this is obvious - the potential rewards are very large, and many investors feel confident that they can achieve such awards even if other investors cannot.

The most traditional and popular form of active stock strategies is the selection of individual stocks identified as offering superior return-risk characteristics. Such stocks typically are selected using fundamental security analysis, but technical analysis is also used, and sometimes a combination of the two. Many investors have always believed, and continue to believe despite evidence to the contrary from the EMH, that they possess the requisite skill, patience, and ability to identify undervalued stocks.

Building an Investment Portfolio

Asset Allocation

We now consider how investors go about selecting stocks to be held in portfolios. Individual investors often consider the investment decision as consisting of two steps:

- **Asset allocation**
- **Security selection**

The asset allocation decision refers to the allocation of portfolio assets to broad asset markets; in other words, how much of the portfolio's funds is to be invested in stocks, how much in bonds, money market assets, and so forth. Each weight can range from zero percent to 100 percent. Examining the asset allocation decision globally leads us to ask the following questions:

1. What percentage of portfolio funds is to be invested in each of the countries for which financial markets are available to investors?
2. Within each country, what percentage of portfolio funds is to be invested in stocks, bonds, bills, and other assets?
3. Within each of the major asset classes, what percentage of portfolio funds is to go to various types of bonds, exchange-listed stocks versus over-the-counter stocks, and so forth?

Many knowledgeable market observers agree that the asset allocation decision may be the most important decision made by an investor. According to some studies, for example, the asset allocation decision accounts for more than 90 percent of the variance in quarterly returns for a typical large pension fund.

According to some analyses, asset allocation is closely related to the age of an investor. This



involves the so-called *life-cycle theory of asset allocation*. This makes intuitive sense because the needs and financial positions of workers in their 50s should differ, on average, from those who are starting out in their 20s. According to the life-cycle theory, for example, as individuals approach retirement they become more risk averse.

Asset Classes

Portfolio construction begins with the basic building blocks of asset classes, which are the following major categories of investments:

- Cash (or cash equivalents such as money market funds)
- Stocks
- Bonds
- Real Estate (including Real Estate Investment Trusts)
- Foreign Securities

Each investor must determine which of these major categories of investments is suitable for him / her. The next step, as discussed in the preceding section on asset allocation, is to determine which percentage of total investable assets should be allocated to each category deemed appropriate. Only then, should individual securities be considered within each asset class.

Diversification

The insurance principle illustrates the concept of attempting to diversify the risk involved in a portfolio of assets (or liabilities). In fact, diversification is the key to the management of portfolio risk because it allows investors to minimize risk without adversely affecting return.

Random or naïve diversification refers to the act of randomly diversifying without regard to relevant investment characteristics such as expected return and industry classification. An investor simply selects a relatively large number of securities randomly – the proverbial “throwing a dart at *The Wall Street Journal* page showing stock quotes.”

Risk Reduction in the Stock Portion of a Portfolio

Law of Large Numbers

Assume that all risk sources in a portfolio of securities are independent. As we add securities to this portfolio, the exposure to any particular source of risk becomes small. According to the *Law of Large Numbers*, the larger the sample size, the more likely it is that the sample mean will be close to the population expected value. Risk reduction in the case of independent risk sources can be thought of as the *insurance principle*, named for the idea that an insurance company reduces its risk by writing many policies against many independent sources of risk.

A Strategy for Everyone

We have demonstrated a superior investment strategy. Looking forward, our strategy should yield superior results while limiting risk for long-term investors in almost any economic environment short of unlimited nuclear war or total global economic collapse.

Whether you are playing tennis, flying fighters, or practicing medicine, you should be constantly looking for the highest probability shot. The combination of Strategic Global Asset



Allocation and Modern Portfolio Theory (with an appreciation of the cross section of expected returns in various parts of the world's markets) offers investors the highest probability shot of making their objectives a reality.

VALUE INVESTING

This style of investing termed as conservative investing. In the case of value investing, bargains are often measured in terms of market prices that are below the estimated current economic value of tangible and intangible assets. Value investors pick up shares at attractive low prices. They are characterised by maintaining a portfolio of market under performers, equipment, or other financial holdings in subsidiaries or other companies, and real estate. Value investors, who select only cheap shares that are very infrequently traded are called deep-value investors. Some value investors focus on companies at the brink of bankruptcy or in the midst of bankruptcy proceedings. The value investors' portfolio will have shares that have been undervalued by the market. Such value investing is suitable in a market economy that is facing depression. Most value investors' focus on tangible assets such as plant. Cyclical shares also become a favourite with value investors when recession hits and economically sensitive shares get undue importance due to short term investors focussing on temporarily adverse sales and earnings information.

GROWTH INVESTING

The strategy of growth investors is to identify the shares whose future returns are expected to grow at a fast rate. Growth investment style identifies shares based on the growth potential of companies. These types of investors look into the future potential returns from the company. Historical returns need not exhibit a close relationship with growth rate or historical earnings per share.

Growth investors considers several factors to identify superior performing securities for purchase. Some of the factors that are looked into are short run and long run high growth rates from sales and EPS, high profit margin and notable increase in projected earnings for both three and five years. Growth companies are also identified through comparison with industry averages. If the company has superior expected growth rates compared with the industry averages, such companies are considered as growth companies. Growth shares also show distinctive cost advantage over other companies and are marked by high pay scales to attract talented employees. It is not always possible to identify the growth shares in all capital market situations. Many situations might arise, which would make the identification of growth shares very difficult. Also, the identified growth shares might change their characteristics and might often result in unexpected losses for the investor

PERFORMANCE INDEX

Portfolio performance evaluation is a component of the portfolio management process. Specifically, it can be viewed as a feedback and control mechanism that identifies superior performance and makes the investment management process successful. Superior performance of a portfolio may have been the result of good portfolio management decisions / styles or due to chance. Conversely, inferior performance of a portfolio could also be attributed to a chance factor or due to costs associated with unscientific portfolio management.



Portfolio performance is evaluated over a specific time period. The most often used risk adjusted portfolio performance measures are the:

- Sharpe's Portfolio Performance Measure;
- Treynor Portfolio Performance Measure; and
- Jensen Portfolio Performance Measure

Portfolio Theory

A theory on how risk-averse investors can construct portfolios to optimize or maximize expected return based on a given level of market risk, emphasizing that risk is an inherent part of higher reward. Also called "portfolio theory" or "portfolio management theory."

According to the theory, it's possible to construct an "efficient frontier" of optimal portfolios offering the maximum possible expected return for a given level of risk. This theory was pioneered by Harry Markowitz in his paper "Portfolio Selection," published in 1952 by the *Journal of Finance*.

There are four basic steps involved in portfolio construction:

- Security valuation
- Asset allocation
- Portfolio optimization
- Performance measurement

The Theory

One of the most important and influential economic theories dealing with finance and investment, MPT was developed by Harry Markowitz and published under the title "Portfolio Selection" in the 1952 *Journal of Finance*. MPT says that it is not enough to look at the expected risk and return of one particular stock. By investing in more than one stock, an investor can reap the benefits diversification - chief among them, a reduction in the riskiness of the portfolio. MPT quantifies the benefits of diversification, also known as not putting all of your eggs in one basket.

For most investors, the risk they take when they buy a stock is that the return will be lower than expected. In other words, it is the deviation from the average return. Each stock has its own standard deviation from the mean, which MPT calls "risk".

The risk in a portfolio of diverse individual stocks will be less than the risk inherent in holding any single one of the individual stocks (provided the risks of the various stocks are not directly related). Consider a portfolio that holds two risky stocks: one that pays off when it rains and another that pays off when it doesn't rain. A portfolio that contains both assets will always pay off, regardless of whether it rains or shines. Adding one risky asset to another can reduce the overall risk of an all-weather portfolio.

Portfolio Selection Problem

What is the opportunity set of investments or portfolios from which an investor must take a choice? A quick reflection on equations above equation, would reveal that there are infinite number of possibilities to combine n assets into a portfolio, provided an investor can hold a fraction of an asset if he or she so desires. Each one of these portfolios available for investment corresponds to a set of portfolio weights (i.e., the proportions of fund that investors may allocate to different assets), and is characterized by an expected rate of return and variance (or standard deviation)

Does an investor need to evaluate all the portfolios of 'feasible set' to determine his or her 'best' or 'optimal' portfolio? Fortunately, the answer to this question is 'no'. The investor is required to examine only a subset of feasible set of portfolios.

Generally The investors would, however, prefer some of them to others. Since the investors are assumed to be risk averse and prefer more return to less, their choice of portfolios will be bounded by the following two criteria:

1. Given two portfolios with the same expected return, prefer the one with the least risk exposure.
2. Given two portfolio with the same risk exposures, prefer the one with the higher expected return.

Not all the portfolios will conform to these criteria. And, hence, an investor's choice set will be reduced from an infinite possible combination of assets to the set of portfolio meeting the criteria. This set of portfolios is termed as 'efficient set' or 'efficient frontier'.

Selection of Optimal Portfolio

The actual computational procedure for locating efficient frontier is much more complex than what it might appear to be from our geometric interpretations. We need to employ some optimisation technique, and this we will discuss in next unit. Meanwhile, let us search for an optimal portfolio from the efficient set.

Once the location and composition of the efficient set have determined, the selection of optimal portfolio by an investor will depend on his/her 'risk tolerance' or 'trade-offs between risk and expected return'. For instance, a risk-averse investor, such as a person nearing retirement, may prefer an efficient portfolio with low risk (as measured by standard deviation or variance), whereas a risk taker may prefer a portfolio with greater risk and commensurately higher returns.

Portfolio selection process entails four basic steps:

Step 1: Identifying the assets to be considered for portfolio construction.

Step 2: Generating the necessary input data to portfolio selection; this involves estimating the expected returns, variances and covariance's for all the assets considered.

Step 3: Delineating the efficient portfolio.

Step 4: Given an investor's risk tolerance level, selecting the optimal portfolio in terms of: (a) the assets to be held; and (b) the proportion of available funds to be allocated to each.



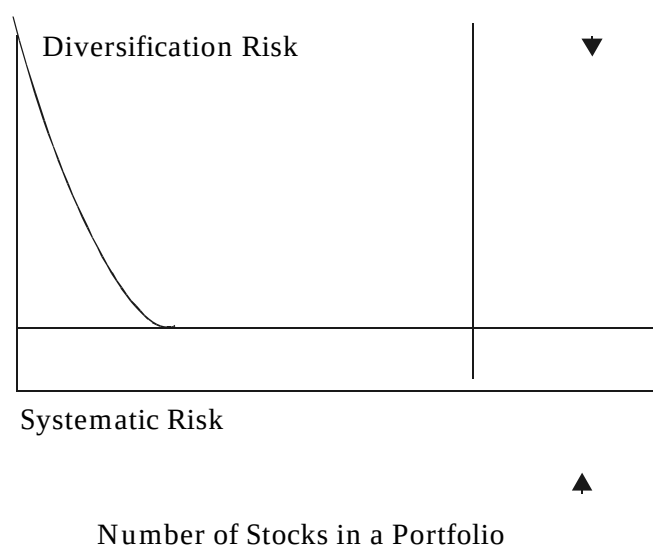
The portfolio selection process as described above is not something new; the model was presented by Harry Markowitz briefly in 1952 and later in a complete book entitled *Portfolio Selection-Efficient Diversification of Investments* (1959). One important concept that Markowitz emphasized for the first time was that some measure of risk, and not just the expected rate of return, should be considered when dealing with investment decision. Markowitz's approach to portfolio analysis and selection attracted a number of academicians and practitioners, who subsequently began to adjust the basic framework so that practical application could be more readily considered. Another interesting thing happened. Following the presentation of the model, there had been a wide spread realization of how computers could be utilized in investment decision-making. Markowitz's own solution to portfolio selection problem necessitates, as we will see in the next unit, application of computers. As a final remark, we may mention that Markowitz's work marks the beginnings of what is today known as modern portfolio theory.

MARKOWITZ DIVERSIFICATION AND CLASSIFICATION OF RISKS

In all our earlier illustrations, we have seen that the Portfolio Risk is smaller than the risk of individual assets. It indicates that the Portfolios are less risky than the isolated Assets. This phenomenon has been often attributed to Markowiz contribution. If an investor intends to diversify his investment into different assets instead of investing the whole in one security, he is with to benefit from reduced risk level. Further, if he can find assets with negative correlation, the combined risk works out zero or near zero. But in reality it is difficult to find many assets with negative correlation.

What will happen to portfolio risk if we go on adding more and more stocks to a Portfolio? It is logical to believe that the risk is bound to reduce . as the number of stocks in a portfolio increases. Can we eliminate risk completely it all depends an the correlation in between Assets. Smaller the correlations, lower will be the risk in the Portfolio. In act, if we car, find stocks with either zero correlation or negative correlation, the portfolilo would he certainly low. But it is impossible to find such stocks to construct our Portfolios. In such a case there exists a minimum level of risk in every portfolio, however large the number of Assets in it may be,

Effect of Portfolio Size on Portfolio Risk



Observe the above diagram which depicts the decline in size of portfolio risk as the number of individual stocks increase in a portfolio. That portion of the total risk which declines due to diversification of investment, from a single asset to others is called diversifiable risk or firm specific risk. It may arise due to the internal firm level or company level or industry level reasons like strikes and lock outs, sudden fall in demand for the product, entry of new technology, specific governmental restrictions, fluctuating growth to the given industry. On the other hand, the diversifiable risk which is also called 'systematic risk', is that portion of risk which cannot be further reduced by adding any number of newer scrips to the given portfolio. It is called 'systematic' or market risk' as the reasons like general changes in the economy, political and market fluctuations, inflation and interest rates which have a common bearing on all stocks. As these factors simultaneously affect all industries as well as firms alike this risk is universal to all risky assets.

This aspect brings a new dimension to the risk return analysis. In efficient markets Assets are expected to be priced in such a way that they yield a return proportional to the size of risk that the asset carries. Which risk is generally rewarded? Is it the total risk that the asset brings or something else? Certainly market is not expected to reward the risk which can be diversified by putting investment across different stocks. Then the relevant individual is its contribution systematic risk of an individual stock is its contribution to the systematic risk in well diversified portfolio. How to identify this contribution? William F. Sharpe has given an answer to this. He has established the contribution of each single asset to the portfolio risk by developing a Single-Index Market Model'.

Traditional Portfolio Analysis

Traditional security analysis recognizes the key importance of risk and return to the investor traditional approaches which really upon intuition and insight. The result of these rather subjective approaches to portfolio analysis.

Most traditional methods recognize return as some dividend receipts and price appreciation over a forward period portfolio or combination of securities are thought of as helping to spread risk over many securities

Modern portfolio theory

Portfolio management is concerned with efficient management of investment in the securities. An investment is defined as the current commitment of funds for a period in order to derive a future flow of funds that will compensate the investing unit:

- (a) for the time the funds are committed
- (b) for the expected rate of inflation
- (c) for the uncertainty involved in the future flow of funds

The portfolio management deals with the process of selection of securities from the number of opportunities available with different expected returns and carrying different levels of risk and the selection of securities is made with a view to provide the investors the maximum yield for a given level of risk or ensure minimise risk for a given level of return.

Markowitz Mean-Variance Model

Harry Markowitz is regarded as the father of modern portfolio theory. According to him, investors are mainly concerned with two properties of an asset: risk and return, but by diversifica-



tion of portfolio it is possible to trade off between them. The essence of his theory is that risk of an individual asset hardly matters to an investor. What really counts is the contribution it makes to the investor's total risk. By turning his principle into a useful technique for selecting the right portfolio from a range of different assets, he developed 'Mean Variance Analysis' in 1952. The thrust has been on balancing safety, liquidity and return depending on the taste of different investors. The portfolio selection problem can be divided into two stages, first finding the mean-variance efficient portfolios and secondly selecting one such portfolio. Investors do not like risk and the greater the riskiness of returns on an investment, the greater will be the returns expected by investors. There is a tradeoff between risk and return which must be reflected in the required rates of return on investment opportunities. The standard deviation (or variance) of return measures the total risk of an investment. It is not necessary for an investor to accept the total risk of an individual security. Investors can and do diversify to reduce risk. As number of holdings approach larger, a good deal of total risk is removed by diversification.

Assumptions

This model has taken into account of risks associated with investments - using variance or standard deviation of the return. This model is based on the following assumptions:

- The return on an investment adequately summarises the outcome of the investment.
- All investors are risk averse. For a given expected return he prefers to take minimum risk, obviously for a given level of risk the investor prefers to get maximum expected return.
- Investors are assumed to be rational in so far as they would prefer greater returns to lesser ones given equal or smaller risk and risk averse. Risk aversion in this context means merely that, as between two investments with equal expected returns, the investment with the smaller risk would be preferred.
- 'Return' could be any suitable measure of monetary inflows such as NPV, but yield has been the most commonly used measure of return, in this context, so that where the standard deviation of returns is referred to we shall mean the standard deviation of yield about its expected value.
- The investors can visualise a probability distribution of rates of return.
- The investors' risk estimates are proportional to the variance of return they perceive for a security or portfolio.
- Investors base their investment decisions on two criteria i.e., expected return and variance of return.

Efficient Frontier

Markowitz has formulated the risk return relationship and developed the concept of efficient frontier. For selection of a portfolio, comparison between a combination of portfolios is essential. As a rule, a portfolio is not efficient if there is another portfolio with:

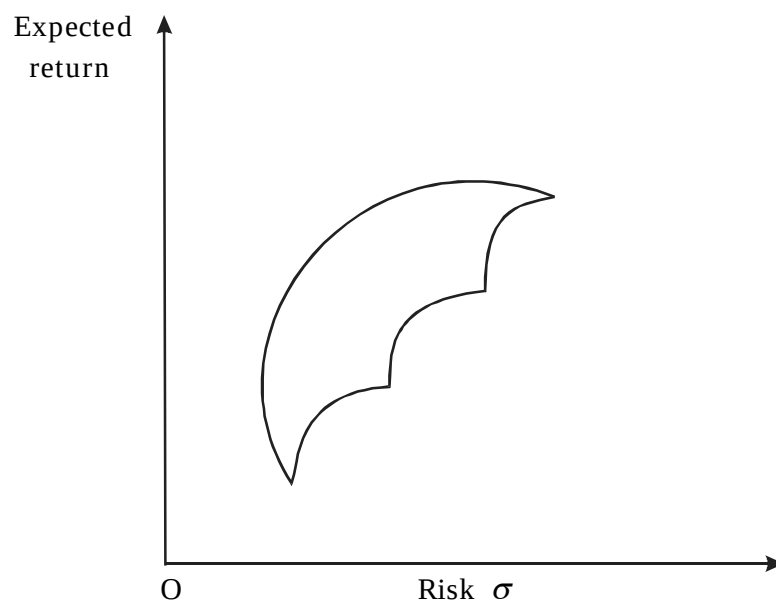
- a higher expected value of return and a lower standard deviation (risk)
- a higher expected value of return and the same standard deviations (risk).
- the same expected value but a lower standard deviation (risk).

Markowitz has defined the diversification as the process of combining assets that are less than perfectly positively correlated in order to reduce portfolio risk without sacrificing any portfolio returns. If an investor's portfolio is not efficient he may:

- increase the expected value of return without increasing the risk.
- decrease the risk without decreasing the expected value of return, or
- obtain some combination of increase of expected return and decreased risk.

This is possible by switching to a portfolio on the efficient frontier.

If all the investments are plotted on the risk-return sphere, individual securities would be dominated by portfolios, and the efficient frontier would be taken shape indicating investments which yield maximum return given the level of risk bearable, or which minimises risk given the expected level of return. Figure 34.1 depicts the boundary of possible investments in securities A, B, C, D, E and F; and B, C, D are lying on the efficient frontier.



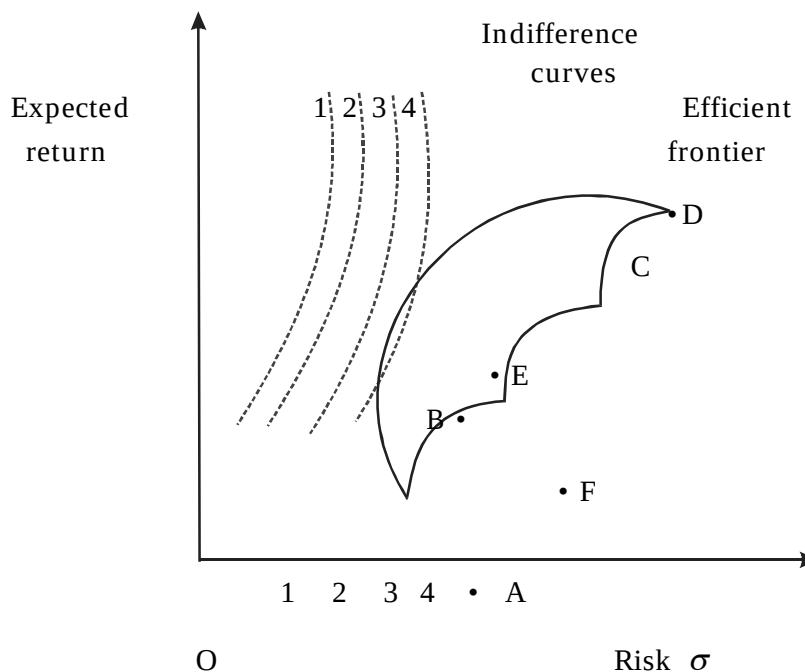
MARKOWITZ EFFICIENT FRONTIER

The best combination of expected value of return and risk (standard deviation) depends upon the investors utility function. The individual investor will want to hold that portfolio of securities that places him on the highest indifference curves, choosing from the set of available portfolios. The dark line at the top of the set is the line of efficient combinations, or the efficient frontier. It depicts the tradeoff between risk and expected value of return.

The optimal investment achieved at a point where the indifference curve is at a tangent to the efficient frontier. This point reflects the risk level acceptable to the investor in order to achieve



a desired return and provide maximum return for the bearable level of risk. The concept of efficient frontier, and the optimal point location is explained with help of Figure 34.2. A, B, C, D, E and F define the boundary of all possible investments out of which investments in B, C and D are the efficient proposals lying on the efficient frontier. The attractiveness of the investment proposals lying on the efficient frontier, depends on the investors attitude to risk. At point B, the level of risk and return is at optimum level. The returns are highest at point D, but simultaneously it carries higher risk than any other investment.



The shaded area represents all attainable portfolios, that is all the combinations of risk and expected return which may be achieved with the available securities. The efficient frontier denotes all possible efficient portfolios and any point on the frontier dominates any point to the right of it.

Use of matrix approach in Investment Decision

The product portfolio matrix approach propounded by the Boston Consulting Group may be related to the product life cycle by letting the introduction stage begin in the question mark quadrant; growth starts toward the end of this quadrant and continues well into the star quadrant. Going down from the star to the cash cow quadrant, the maturity stage begins. Decline is positioned between the cash cow and the dog quadrants. Ideally, a company should enter the product/market segment in its introduction stage, gain market share in the growth stage, attain a position of dominance when the product/market segment enters its maturity stage, maintain this dominant position until the product/market segment enters its decline stage, and then determine the optimum point for liquidation.

Balanced and Unbalanced Portfolios Unbalanced portfolios may be classified into four types:

1. Too many losers (due to inadequate cash flow, inadequate profits, and inadequate growth).
2. Too many question marks (due to inadequate cash flow and inadequate profits).
3. Too many profit producers (due to inadequate growth and excessive cash flow).
4. Too many developing winners (due to excessive cash demands, excessive demands on management, and unstable growth and profits).

The company has just one cash cow, three question marks, and no stars. Thus, the cash base of the company is inadequate and cannot support the question marks. The company may allocate available cash among all question marks in equal proportion. Dogs may also be given occasional cash nourishment. If the company continues its current strategy, it may find itself in a dangerous position in five years, particularly when the cash cow moves closer to becoming a dog. To take corrective action, the company must face the fact that it cannot support all its question marks. It must choose one or maybe two of its three question marks and fund them adequately to make them stars. In addition, disbursement of cash in dogs should be totally prohibited. In brief, the strategic choice for the company, considered in portfolio terms, is obvious. It cannot fund all question marks and dogs equally. The portfolio matrix focuses on the real fundamentals of businesses and their relationships to each other within the portfolio. It is not possible to develop effective strategy in a multiproduct, multimarket company without considering the mutual relationships of different businesses.

Conclusion The portfolio matrix approach provides for the simultaneous comparison of different products. It also underlines the importance of cash flow as a strategic variable. Thus, when continuous long-term growth in earnings is the objective, it is necessary to identify high-growth product/market segments early, develop businesses, and preempt the growth in these segments. If necessary, short-term profitability in these segments may be forgone to ensure achievement of the dominant share. Costs must be managed to meet scale-effect standards. The appropriate point at which to shift from an earnings focus to a cash flow focus must be determined and a liquidation plan for cash flow maximization established. A cash-balanced mix of businesses should be maintained. Many companies worldwide have used the portfolio matrix approach in their strategic planning. The first companies to use this approach were the Norton Company, Mead, Borg-Warner, Eaton, and Monsanto. Since then, virtually all large corporations have reported following it. The portfolio matrix approach, however, is not a panacea for strategy development. In reality, many difficulties limit the workability of this approach. Some potential mistakes associated with the portfolio matrix concept are

1. Overinvesting in low-growth segments (lack of objectivity and “hard” analysis).
2. Underinvesting in high-growth segments (lack of guts).
3. Misjudging the segment growth rate (poor market research).
4. Not achieving market share (because of improper market strategy, sales capabilities, or promotion).
5. Losing cost effectiveness (lack of operating talent and control system).
6. Not uncovering emerging high-growth segments (lack of corporate development effort).
7. Unbalanced business mix (lack of planning and financial resources).



Thus, the portfolio matrix approach should be used with great care.

MULTIFACTOR PORTFOLIO MATRIX

The two-factor portfolio matrix discussed above provides a useful approach for reviewing the roles of different products in a company. However, the growth rate relative market share matrix approach leads to many difficulties. At times, factors other than market share and growth rate bear heavily on cash flow, the mainstay of this approach. Some managers may consider return on investment a more suitable criterion than cash flow for making investment decisions. Further, the twofactor portfolio matrix approach does not address major investment decisions between dissimilar businesses. These difficulties can lead a company into too many traps and errors. For this reason, many companies (such as GE and the Shell Group) have developed the multifactor portfolio approach. It is worthwhile to mention that the development of a multifactor matrix may not be as easy as it appears. The actual analysis required may take a considerable amount of foresight and experience and many, many days of work. The major difficulties lie in identifying relevant factors, relating factors to industry attractiveness and business strengths, and weighing the factors.

Strategy Development The area of the circle refers to the business's sales. Investment priority is given to products in the high area (upper left), where a stronger position is supported by the attractiveness of an industry. Along the diagonal, selectivity is desired to achieve a balanced earnings performance. The businesses in the low area (lower right) are the candidates for harvesting and divestment. A company may position its products or businesses on the matrix to study its present standing. Forecasts may be made to examine the directions different businesses may go in the future, assuming no changes are made in strategy. Future perspectives may be compared to the corporate mission to identify gaps between what is desired and what may be expected if no measures are taken now. Filling the gap requires making strategic moves for different businesses. Once strategic alternatives for an individual business have been identified, the final choice of a strategy should be based on the scope of the overall corporation vis-à-vis the matrix.

For example, the prospects for a business along the diagonal may appear good, but this business cannot be funded in preference to a business in the highhigh cell. In devising future strategy, a company generally likes to have a few businesses on the left to provide growth and to furnish potential for investment and a few on the right to generate cash for investment in the former. The businesses along the diagonal may be selectively supported (based on resources) for relocation on the left. For an individual business, there can be four strategy options: investing to maintain, investing to grow, investing to regain, and investing to exit. The choice of a strategy depends on the current position of the business in the matrix (i.e., toward the high side, along the diagonal, or toward the low side) and its future direction, assuming the current strategic perspective continues to be followed. If the future appears unpromising, a new strategy for the business is called for. Analysis of present position on the matrix may not pose any problem. At GE, for example, there was little disagreement on the position of the business. The mapping of future direction, however, may not be easy. A rigorous analysis must be performed, taking into account environmental shifts, competitors' perspectives, and internal strengths and weaknesses. Strategy to maintain the current position may be adopted if, in the absence of a new strategy, erosion is expected in the future. Investment will be sought to hold the position;

hence, the name invest-to-maintain strategy. The second option is the invest-to-grow strategy. Here, the product's current position is perceived as less than optimum vis-à-vis industry attractiveness and business strengths. In other words, considering the opportunities furnished by the industry and the strengths exhibited by the business, the current position is considered inadequate.

A growth strategy is adopted with the aim of shifting the product position upward or toward the left. Movement in both directions is an expensive option with high risk. The invest-to-regain strategy is an attempt to rebuild the product or business to its previous position. Usually, when the environment (i.e., industry) continues to be relatively attractive but the business position has slipped because of some strategic past mistake (e.g., premature harvesting), the company may decide to revitalize the business through new investments. The fourth and final option, the invest-to-exit strategy, is directed toward leaving the market through harvesting or divesting. Harvesting amounts to making very low investments in the business so that in the short run the business will secure positive cash flow and in a few years die out. (With no new investments, the position will continue to deteriorate.) Alternatively, the whole business may be divested, that is, sold to another party in a one-time deal. Sometimes small investments may be made to maintain the viability of business if divestment is desired but there is no immediate suitor. In this way the business can eventually be sold at a higher price than would have been possible right away.

Unit of Analysis The framework discussed here may be applied to either a product / market or an SBU. As a matter of fact, it may be equally applicable to a much higher level of aggregation in the organization, such as a division or a group. Of course, at the group or division level, it may be very difficult to measure industry attractiveness and business strengths unless the group or division happens to be in one business. In the scheme followed in this article, the analysis may be performed first at the SBU level to determine the strategic perspective of different products / markets. Finally, all SBUs may be simultaneously positioned on the matrix to determine a corporate-wide portfolio.

Directional Policy Matrix

A slightly different technique, the directional policy matrix, is popularly used in Europe. It was initially worked out at the Shell Group but later caught the fancy of many businesses across the Atlantic. The two sides of the matrix are labeled business sector prospects (industry attractiveness) and company's competitive capabilities (business strengths). *Business sector prospects* are categorized as unattractive, average, and attractive; and the *company's competitive capabilities* are categorized as weak, average, and strong. Within each cell is the overall strategy direction for a business depicted by the cell. The consideration of factors used to measure business sector prospects and a company's competitive capabilities follows the same logic and analyses discussed above.

PORTFOLIO MATRIX: CRITICAL ANALYSIS In recent years, a variety of criticisms have been leveled at the portfolio framework. Most of the criticism has centered on the Boston Consulting Group matrix.

1. A question has been raised about the use of market share as the most important influence on marketing strategy. The BCG matrix is derived from an application of the learning



curve to manufacturing and other costs. It was observed that, as a firm's product output (and thus market share) increases, total cost declines by a fixed percentage. This may be true for commodities; however, in most product/market situations, products are differentiated, new products and brands are continually introduced, and the pace of technological changes keeps increasing. As a result, one may move from learning curve to learning curve or encounter a discontinuity. More concrete evidence is needed before the validity of market share as a dimension in strategy formulation is established or rejected.

2. Another criticism, closely related to the first, is how product/market boundaries are defined. Market share varies depending on the definition of the corresponding product/market. Hence, a product may be classified in different cells, depending on the market boundaries used.
3. The stability of product life cycles is implicitly assumed in some portfolio models. However, as in the case of the learning curve, it is possible for the product life cycle to change during the life of the product. For example, recycling can extend the life cycle of a product, sparking a second growth stage after maturity. A related subissue concerns the assumption that investment is more desirable in high-growth markets than in low-growth ones. There is insufficient evidence to support this proposition. This overall issue becomes more problematic for international firms because a given product may be in different stages of its life cycle in different countries.
4. The BCG portfolio framework was developed for balancing cash flows. It ignores the existence of capital markets. Cash balancing is not always an important consideration

Key Words

- Portfolio
- Single portfolio
- Optimum Portfolio
- Portfolio strategies
- Phases of portfolio management
- Passive strategies
- Active strategies
- Balanced strategies
- Asset allocation
- Security selection
- Diversification
- Portfolio theory
- Growth index
- Performance index

- Value investing
- Portfolio matrix

Self Study Questions

1. Explain risk reduction in the stock portion of a portfolio
2. What do you mean by building an investment portfolio?
3. Write on portfolio strategies
4. What are the phases of portfolio management?
5. Write Portfolio investment objectives
6. Explain asset allocation / asset mix
7. What do you mean by value investing?
8. What do you understand by growth investing?
9. Explain in detail performance index
10. Write modern theories of portfolio
11. How helpful is use of matrix approach in investment decision
12. Write on multifactor portfolio matrix

3.10 MUTUAL FUND

Unit Content

- Role of mutual fund in financial market
- Advantages of investing in mutual fund
- Regulations of operation
- Investors right and obligation

Concept of Mutual Fund

Mutual funds are money-managing institutions set up to professionally invest the money pooled in from the public. These schemes are managed by Asset Management Companies (AMC), which are sponsored by different financial institutions or companies. Each unit of these schemes reflects the share of investor in the respective fund and its appreciation is judged by the Net Asset Value (NAV) of the scheme. The NAV is directly linked to the bullish and bearish trends of the markets as the pooled money is invested either in equity shares or in debentures or treasury bills. Indian Mutual Funds unveils this multi-dimensional avenue, with its intricacies, in a fashionable manner as mutual funds up-hold ample scope of generating decent returns by some thoughtful investment

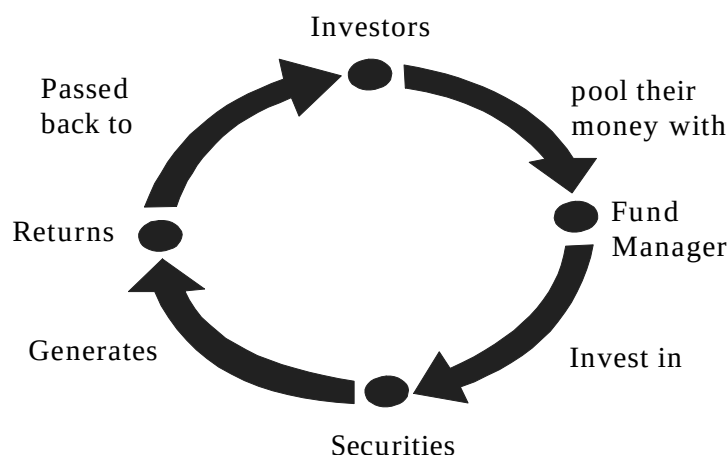
Mutual Fund has been defined by various authors in different ways. According to Pierce, James L, it is a non-depository or non-banking financial intermediary which acts as an “important vehicle for bringing wealth holders and deficit units together directly”

Weston, J. Fred and Brigham, Eugene F, in their book “Essentials of Managerial Finance” state that Mutual Funds are corporations which accept dollars from savers and then use these dollars to buy stock, long term bonds, short term debt instruments issued by business or government. These corporations pool funds and thus reduce risk by diversification.

Mutual Fund is essentially a mechanism of pooling together the savings of a large number of small investors for collective investment, with an avowed objective of attractive yields and capital appreciation, holding the safety and liquidity as prime parameters.

According to Author:

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realised are shared by its unit holders in proportion to the number of units owned by them. Thus a Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost. The flow chart below describes broadly the working of a mutual fund:



Mutual Fund Operation Flow Chart

History of Mutual Funds Industry in India

The origin of mutual fund industry in India is with the introduction of the concept of mutual fund by UTI in the year 1963. Though the growth was slow, but it accelerated from the year 1987 when non-UTI players entered the industry.

In the past decade, Indian mutual fund industry had seen a dramatic improvements, both qualitywise as well as quantitywise. Before, the monopoly of the market had seen an ending

phase, the Assets Under Management (AUM) was Rs. 67bn. The private sector entry to the fund family rose the AUM to Rs. 470 bn in March 1993 and till April 2004, it reached the height of 1,540 bn.

Putting the AUM of the Indian Mutual Funds Industry into comparison, the total of it is less than the deposits of SBI alone, constitute less than 11% of the total deposits held by the Indian banking industry.

The main reason of its poor growth is that the mutual fund industry in India is new in the country. Large sections of Indian investors are yet to be intellectualized with the concept. Hence, it is the prime responsibility of all mutual fund companies, to market the product correctly abreast of selling.

The mutual fund industry can be broadly put into four phases according to the development of the sector. Each phase is briefly described as under.

First Phase - 1964-87

Unit Trust of India (UTI) was established on 1963 by an Act of Parliament. It was set up by the Reserve Bank of India and functioned under the Regulatory and administrative control of the Reserve Bank of India. In 1978 UTI was de-linked from the RBI and the Industrial Development Bank of India (IDBI) took over the regulatory and administrative control in place of RBI. The first scheme launched by UTI was Unit Scheme 1964. At the end of 1988 UTI had Rs.6,700 crores of assets under management.

Second Phase - 1987-1993 (Entry of Public Sector Funds)

Entry of non-UTI mutual funds. SBI Mutual Fund was the first followed by Canbank Mutual Fund (Dec 87), Punjab National Bank Mutual Fund (Aug 89), Indian Bank Mutual Fund (Nov 89), Bank of India (Jun 90), Bank of Baroda Mutual Fund (Oct 92). LIC in 1989 and GIC in 1990. The end of 1993 marked Rs.47,004 as assets under management.

Third Phase - 1993-2003 (Entry of Private Sector Funds)

With the entry of private sector funds in 1993, a new era started in the Indian mutual fund industry, giving the Indian investors a wider choice of fund families. Also, 1993 was the year in which the first Mutual Fund Regulations came into being, under which all mutual funds, except UTI were to be registered and governed. The erstwhile Kothari Pioneer (now merged with Franklin Templeton) was the first private sector mutual fund registered in July 1993.

The 1993 SEBI (Mutual Fund) Regulations were substituted by a more comprehensive and revised Mutual Fund Regulations in 1996. The industry now functions under the SEBI (Mutual Fund) Regulations 1996

The number of mutual fund houses went on increasing, with many foreign mutual funds setting up funds in India and also the industry has witnessed several mergers and acquisitions. As at the end of January 2003, there were 33 mutual funds with total assets of Rs. 1,21,805 crores. The Unit Trust of India with Rs.44,541 crores of assets under management was way ahead of other mutual funds.

Fourth Phase - since February 2003

This phase had bitter experience for UTI. It was bifurcated into two separate entities. One is the Specified Undertaking of the Unit Trust of India with AUM of Rs.29,835 crores (as on January 2003). The Specified Undertaking of Unit Trust of India, functioning under an administrator

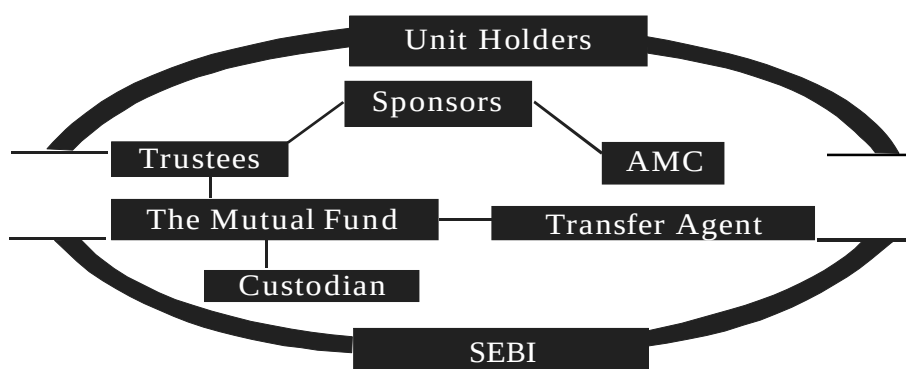


and under the rules framed by Government of India and does not come under the purview of the Mutual Fund Regulations.

The second is the UTI Mutual Fund Ltd, sponsored by SBI, PNB, BOB and LIC. It is registered with SEBI and functions under the Mutual Fund Regulations. With the bifurcation of the erstwhile UTI which had in March 2000 more than Rs.76,000 crores of AUM and with the setting up of a UTI Mutual Fund, conforming to the SEBI Mutual Fund Regulations, and with recent mergers taking place among different private sector funds, the mutual fund industry has entered its current phase of consolidation and growth. As at the end of September, 2004, there were 29 funds, which manage assets of Rs.153108 crores under 421 schemes

Mutual Funds - Organisation

There are many entities involved and the diagram below illustrates the organisational set up of a mutual fund:



Organisation of a Mutual Fund

Organisation of Mutual Funds

A Mutual fund can be constituted either as a corporate entity or as a trust. In India, UTI was set up as a corporation under an Act of Parliament in 1964. Indian banks when permitted to operate mutual funds were asked to create trusts to run these funds. The basic difference between a corporation and a trust is that in the case of the former, the liability is limited whereas in case of the later it is unlimited. Also a corporation enjoys the status of separate legal entity who can act on its behalf. A trust has to work on behalf of its trustees. Indian banks operating mutual funds had made a convincing plea before the government to allow their mutual funds to constitute them as 'Asset Management Companies'. The Department of Company Affairs, Ministry of Law, Justice and Company Affairs has issued guidelines in respect of registration of Asset Management Companies (AMCs), in consultation with Securities and Exchange Board of India, as follows:

(a) Approval of AMC by SEBI

As per guidelines, AMC shall be authorized for business by SEBI on the basis of certain criteria and the Memorandum and Articles of Association of the AMC would have to be approved by



SEBI. Accordingly, no company can register an AMC under the Companies Act 1956 without the Memorandum and Articles of Association being approved by SEBI.

(b) Authorised capital of AMC

The primary objective of setting up of an AMC is to manage the assets of the mutual funds and other activities, which it can carry out, such as, financial services consultancy which do not conflict with the fund management activity and are only secondary and incidental. That being so, it may not be practical to expect a company to be set up with a paid up capital of Rs. 5 crores to carry on only incidental activities, without any assurance of its receiving an approval from SEBI to act also as an Asset Management Company for a Mutual Fund. There, should, therefore, be not any objection in registering an AMC if the authorized capital of such a company is approved by SEBI. Major players who help in running a Mutual Fund are as follows:

a) Registers and Transfer Agents

There major responsibilities include:

- i) Receiving and processing the application form of Mutual Fund
- ii) Issuing of Unit / Share Certificates on behalf of Mutual Fund
- iii) Maintain detailed records of Unit holders transactions
- iv) Purchasing, selling, transferring and redeeming the Unit / Share Certificates
- v) Issuing of income / dividend Warrants, broker Cheques etc.
- vi) Creating security interest on Units / Certificates for allowing loans against them

b) Advertiser

Major responsibilities of an advertiser include:

- i) Helping mutual funds organizers to prepare a media plan for marketing the fund
- ii) Issuing / buying the space in newspapers and other electronic media for advertising the various features of a fund
- iii) Arranging or hoardings at public places

c) Advisor/manager:

It is generally a corporate entity who does the following jobs:

- i) Professional advice on the Fund's investments,
- ii) Advice on Asset Management Services.

d) Trustees:

Trustees provide the overall management services and charge management fee.

e) Custodian:

A custodian which is again a corporate body does the following functions:

- i) Holds securities
- ii) Receives and delivers securities



CAPITAL MARKET ANALYSIS

- iii) Collects income / interest / dividends on the securities
- iv) Holds and process cash

Besides the above, other players are as under

- i) Fund Administrator;
- ii) Fund Accounting Services;
- iii) Legal Advisors;
- iv) Fund Officers;
- v) Underwriters / Distributors;
- vi) Legal Advisors.

All the above agencies play a major role in any mutual fund organized in the US and other European countries as they are separate agencies / corporations independent of the mutual fund. However, in India so far mutual fund. However, in India so far mutual funds have taken the services of the following outside agencies:

- i) Registrars and Transfer Agents
- ii) Advertisers
- iii) Legal Advisors
- iv) Custodians

Advantages of Investing in Mutual Funds

By investing in various Mutual Funds schemes, small investors or middle-income investors seek the following advantages compared to other types of investments:

- I. Investment variety and spread in different industries
- II. Capital appreciation without having to watch the upward or downward performance curves of different scrips.
- III. No impulsive decision making regarding purchase or sale of share / securities, since the funds are managed by expert, professional fund managers who have access to latest detailed information regarding the stock market and individual scrips.
- IV. Liquidity through buy back arrangements of the mutual fund or listing on some stock exchanges after a certain lock-in period
- V. Even the smallest dividend or capital gain gets reinvested, thus enhancing the effective return
- VI. Freedom from paperwork
- VII. Tax benefits on invested amounts / returns or dividends / capital gains

Apart from above other Advantages of Mutual Funds are

The advantages of investing in a Mutual Fund are:



- **Diversification:** The best mutual funds design their portfolios so individual investments will react differently to the same economic conditions. For example, economic conditions like a rise in interest rates may cause certain securities in a diversified portfolio to decrease in value. Other securities in the portfolio will respond to the same economic conditions by increasing in value. When a portfolio is balanced in this way, the value of the overall portfolio should gradually increase over time, even if some securities lose value.
- **Professional Management:** Most mutual funds pay topflight professionals to manage their investments. These managers decide what securities the fund will buy and sell.
- **Regulatory oversight:** Mutual funds are subject to many government regulations that protect investors from fraud.
- **Liquidity:** It's easy to get your money out of a mutual fund. Write a check, make a call, and you've got the cash.
- **Convenience:** You can usually buy mutual fund shares by mail, phone, or over the Internet.
- **Low cost:** Mutual fund expenses are often no more than 1.5 percent of your investment. Expenses for Index Funds are less than that, because index funds are not actively managed. Instead, they automatically buy stock in companies that are listed on a specific index
- Transparency
- Flexibility
- Choice of schemes
- Tax benefits
- Well regulated

Drawbacks of Mutual Funds

Mutual funds have their drawbacks and may not be for everyone:

- **No Guarantees:** No investment is risk free. If the entire stock market declines in value, the value of mutual fund shares will go down as well, no matter how balanced the portfolio. Investors encounter fewer risks when they invest in mutual funds than when they buy and sell stocks on their own. However, anyone who invests through a mutual fund runs the risk of losing money.
- **Fees and commissions:** All funds charge administrative fees to cover their day-to-day expenses. Some funds also charge sales commissions or "loads" to compensate brokers, financial consultants, or financial planners. Even if you don't use a broker or other financial adviser, you will pay a sales commission if you buy shares in a Load Fund.
- **Taxes:** During a typical year, most actively managed mutual funds sell anywhere from 20 to 70 percent of the securities in their portfolios. If your fund makes a profit on its sales, you will pay taxes on the income you receive, even if you reinvest the money you made.



- **Management risk:** When you invest in a mutual fund, you depend on the fund's manager to make the right decisions regarding the fund's portfolio. If the manager does not perform as well as you had hoped, you might not make as much money on your investment as you expected. Of course, if you invest in Index Funds, you forego management risk, because these funds do not employ managers.

CONSTITUTION AND MANAGEMENT OF MUTUAL FUND AND OPERATION OF TRUSTEES, etc.,

Trust Deed to be registered under the Registration Act

14. A mutual fund shall be constituted in the form of a trust and the instrument of trust shall be in the form of a deed, duly registered under the provisions of the Indian Registration Act, 1908 (16 of 1908) executed by the sponsor in favour of the trustees named in such an instrument.

Contents of trust deed

15. (1) The trust deed shall contain such clauses as are mentioned in the Third Schedule and such other clauses which are necessary for safeguarding the interests of the unit holders.
- (2) No trust deed shall contain a clause which has the effect of-
 - (i) limiting or extinguishing the obligations and liabilities of the trust in relation to any mutual fund or the unit holders; or
 - (ii) indemnifying the trustees or the asset management company for loss or damage caused to the unit holders by their acts of negligence or acts of commissions or omissions.

Disqualification from being appointed as trustees

16. (1) A mutual fund shall appoint trustees in accordance with these regulations.
- (2) No person shall be eligible to be appointed as a trustee unless -
 - (a) he is a person of ability, integrity and standing; and
 - (b) has not been found guilty of moral turpitude; and
 - (c) has not been convicted of any economic offence or violation of any securities laws; and
 - (d) has furnished particulars as specified in Form C.
- (3) An asset management company or any of its officers or employees shall not be eligible to act as a trustee of any mutual fund.
- (4) No person who is appointed as a trustee of a mutual fund can be appointed as a trustee of any other mutual fund unless -
 - (a) such a person is an independent trustee referred to in sub-regulation (5); and
 - (b) prior approval of the mutual fund of which he is a trustee has been obtained for such an appointment.



- (5) *Two thirds of the trustees shall be independent persons and shall not be associated with the sponsors or be associated with them in any manner whatsoever [original clause substituted]*⁴
- (6) In case a company is appointed as a trustee then its directors can act as trustees of any other trust provided that the object of the trust is not in conflict with the object of the mutual fund.

Approval of the Board for appointment of trustee

17. (1) No trustee shall initially or any time thereafter be appointed without prior approval of the Board.
[Proviso to Regulation deleted]
- (2) The existing trustees of any mutual fund may form a trustee company to act as a trustee with the prior approval of the Board.

Rights and obligations of the trustees

18. (1) The trustees and the asset management company shall with the prior approval of the Board enter into an investment management agreement.
- (2) The investment management agreement shall contain such clauses as are mentioned in the Fourth Schedule and such other clauses as are necessary for the purpose of making investments.
- (3) The trustees shall have a right to obtain from the asset management company such information as is considered necessary by the trustees.
- (4) The trustees shall ensure before the launch of any scheme that the asset management company has;-
- (a) systems in place for its back office, dealing room and accounting;
 - (b) appointed all key personnel including fund manager(s) for the scheme(s) and submitted their bio-data which shall contain the educational qualifications, past experience in the securities market with the trustees, within 15 days of their appointment;
 - (c) appointed auditors to audit its accounts;
 - (d) appointed a compliance officer to comply with regulatory requirement and to redress investor grievances;
 - (e) appointed registrars and laid down parameters for their supervision;
 - (f) prepared a compliance manual and designed internal control mechanisms including internal audit systems;
 - (g) specified norms for empanelment of brokers and marketing agents.
- (5) The trustees shall ensure that an asset management company has been diligent in empanelling the brokers, in monitoring securities transactions with brokers and avoiding undue concentration of business with any broker.
- (6) The trustees shall ensure that the asset management company has not given any undue or unfair advantage to any associates or dealt with any of the associates of the asset management company in any manner detrimental to interest of the unitholders.



- (7) The trustees shall ensure that the transactions entered into by the asset management company are in accordance with these regulations and the scheme.
- (8) The trustees shall ensure that the asset management company has been managing the mutual fund schemes independently of other activities and have taken adequate steps to ensure that the interest of investors of one scheme are not being compromised with those of any other scheme or of other activities of the asset management company.
- (9) The trustees shall ensure that all the activities of the asset management company are in accordance with the provisions of these regulations.
- (10) Where the trustees have reason to believe that the conduct of business of the mutual fund is not in accordance with these regulations and the scheme they shall forthwith take such remedial steps as are necessary by them and shall immediately inform the Board of the violation and the action taken by them.
- (11) *Each trustee shall file the details of his transactions of dealing in securities with the Mutual Fund on a quarterly basis.]⁶*
- (12) The trustees shall be accountable for, and be the custodian of, the funds and property of the respective schemes and shall hold the same in trust for the benefit of the unit holders in accordance with these regulations and the provisions of trust deed.
- (13) The trustees shall take steps to ensure that the transactions of the mutual fund are in accordance with the provisions of the trust deed.
- (14) The trustees shall be responsible for the calculation of any income due to be paid to the mutual fund and also of any income received in the mutual fund for the holders of the units of any scheme in accordance with these regulations and the trust deed.
- (15) The trustees shall obtain the consent of the unitholders -
 - (a) whenever required to do so by the Board in the interest of the unit-holders; or
 - (b) whenever required to do so on the requisition made by three-fourths of the unit holders of any scheme; or
 - (c) when the majority of the trustees decide to wind up or prematurely redeem the units; or
 - (d) when any change in the fundamental attributes of any scheme or the trust or fees and expenses payable or any other change which would modify the scheme or affect the interest of the unitholders is proposed to be carried out unless the consent of not less than three-fourths of the unit holders is obtained:

Provided that no such change shall be carried out unless three fourths of the unit holders have given their consent and the unit holders who do not give their consent are allowed to redeem their holdings in the scheme.

[Provided further that in case of an open ended scheme, the consent of the unitholders shall not be necessary if:

 - (i) *the change in fundamental attribute is carried out after one year from the date of allotment of units.*

- (ii) *the unitholders are informed about the proposed change in fundamental attribute by sending individual communication and an advertisement is given in English daily newspaper having nationwide circulation and in a newspaper published in the language of the region where the head office of the mutual fund is situated.*
- (iii) *the unitholders are given an option to exit at the prevailing Net Asset Value without any exit load.]⁷*

Explanation: For the purposes of this clause “fundamental attributes” means the investment objective and terms of a scheme.

- (16) The trustees shall call for the details of transactions in securities by the key personnel of the asset management company in his own name or on behalf of the asset management company and shall report to the Board, as and when required.
- (17) The trustees shall quarterly review all transactions carried out between the mutual funds, asset management company and its associates.
- (18) The trustees shall *quarterly*⁸ review the networth of the asset management company and in case of any shortfall, ensure that the asset management company make up for the shortfall as per clause (f) of sub-regulation (1) of regulation 21.
- (19) The trustees shall periodically review all service contracts such as custody arrangements, transfer agency of the securities and satisfy itself that such contracts are executed in the interest of the unitholders.
- (20) The trustees shall ensure that there is no conflict of interest between the manner of deployment of its networth by the asset management company and the interest of the unitholders.
- (21) The trustees shall periodically review the investor complaints received and the redressal of the same by the asset management company.
- (22) The trustees shall abide by the Code of Conduct as specified in the Fifth Schedule.
- (23) The trustees shall furnish to the Board on a half yearly basis, -
 - (a) a report on the activities of the mutual fund;
 - (b) a certificate stating that the trustees have satisfied themselves that there have been no instances of self dealing or front running by any of the trustees, directors and key personnel of the asset management company;
 - (c) a certificate to the effect that the asset management company has been managing the schemes independently of any other activities and in case any activities of the nature referred to in sub-regulation (2) of regulation 24 have been undertaken by the asset management company and has taken adequate steps to ensure that the interest of the unitholders are protected
- (24) The independent trustees referred to in sub-regulation (5) of regulation 16 shall give their comments on the report received from the asset management company regarding the investments by the mutual fund in the securities of group companies of the sponsor.]⁹



(25) Trustees shall exercise due diligence as under:

General Due Diligence:

- i. the Trustees shall be discerning in the appointment of the directors on the Board of the asset management company.
- ii. Trustees shall review the desirability of continuance of the asset management company if substantial irregularities are observed in any of the schemes and shall not allow the asset management company to float new schemes.
- iii. The trustee shall ensure that the trust property is properly protected, held and administered by proper persons and by a proper number of such persons.
- iv. The trustee shall ensure that all service providers are holding appropriate registrations from the Board or concerned regulatory authority.
- v. The Trustees shall arrange for test checks of service contracts.
- vi. Trustees shall immediately report to Board of any special developments in the mutual fund.

B. Specific Due Diligence:

The Trustees shall:

- i. obtain internal audit reports at regular intervals from independent auditors appointed by the Trustees.
 - ii. obtain compliance certificates at regular intervals from the asset management company.
 - iii. hold meeting of trustees more frequently.
 - iv. consider the reports of the independent auditor and compliance reports of asset management company at the meetings of trustees for appropriate action.
 - v. maintain records of the decisions of the Trustees at their meetings and of the minutes of the meetings.
 - vi. prescribe and adhere to a code of ethics by the Trustees, asset management company and its personnel.
 - vii. communicate in writing to the asset management company of the deficiencies and checking on the rectification of deficiencies.
- (26) Notwithstanding anything contained in sub-regulations (1) to (25), the trustees shall not be held liable for acts done in good faith if they have exercised adequate due diligence honestly.
- (27) The independent directors of the trustees or asset management company shall pay specific attention to the following, as may be applicable, namely:-
- i. the Investment Management Agreement and the compensation paid under the agreement.
 - ii. service contracts with affiliates - whether the asset management company has charged higher fees than outside contractors for the same services.

- iii. selection of the asset management company's independent directors
- iv. securities transactions involving affiliates to the extent such transactions are permitted.
- v. selecting and nominating individuals to fill independent directors vacancies.
- vi. code of ethics must be designed to prevent fraudulent, deceptive or manipulative practices by insiders in connection with personal securities transactions.
- vii. the reasonableness of fees paid to sponsors, asset management company and any others for services provided.
- viii. principal underwriting contracts and their renewals.
- ix. any service contract with the associates of the asset management company

TYPES OF MUTUAL FUND SCHEMES

Wide variety of Mutual Fund Schemes exist to cater to the needs such as financial position, risk tolerance and return expectations etc. The table below gives an overview into the existing types of schemes in the Industry.

- **By Structure**
 - Open - Ended Schemes
 - Close - Ended Schemes
 - Interval Schemes
- **By Investment Objective**
 - Growth Schemes
 - Income Schemes
 - Balanced Schemes
 - Money Market Schemes
- **Other Schemes**
 - Tax Saving Schemes
 - Special Schemes
 - Index Schemes
 - Sector Specific Schemes

Mutual Funds are grouped as under:

Open Ended Funds

In open-ended funds, there is no limit to the size of the funds. Investors can invest as and when they like. The purchase price is determined on the basis of Net Asset Value (NAV). NAV is the market value of the fund's assets divided by the number of outstanding shares/ units of the fund.

Close Ended Funds

These funds are fixed in size as regards the corpus of the fund and the number of shares. In close ended funds, no fresh units are created after the original offer of the scheme expires. The



shares / units of these funds are not redeemable at their NAV during their life as are in the case of open ended funds. The shares of such funds are traded in the secondary market on stock exchanges at market prices that may be above or below their NAV.

Income Oriented Funds

These funds offer a return much higher than the bank deposits but with less capital appreciation. The emphasis being on regular returns, the pattern of investments in general is oriented towards fixed income yielding securities like non-convertible debentures of consistently good dividend paying companies, etc.

Growth Oriented Funds

These funds do not offer fixed regular returns but provide substantial capital appreciation in the long run. The pattern of investment in general is oriented towards shares of high growth companies.

Balanced Funds or Income and Growth Oriented Funds

These offer a blend of immediate average returns and reasonable capital appreciation in the long run. The investment portfolio of these kinds of funds are evenly distributed among fixed income bearing corporate securities and common stock with growth potential.

Area Funds

These are the funds which are raised in other countries for providing access to foreign investors. The India Growth Fund and the India Fund raised in the US and U.K respectively are examples of area funds.

Specialised Funds Or Industry Funds

These funds are invested in a particular industry like cement, steel, jute, power or textile, etc. These funds carry high risks with them as the entire fund is exposed to a particular industry. Money Market funds are another

kind of specialized funds. These funds invest in money market instruments only.

Tax Relief Funds

These funds are raised for providing tax relief to those investors whose income comes under taxable limits. Equity Linked Savings Scheme, under Section 80 CCB of the Income Tax Act. 1961, floated by SBI Mutual Fund, PNB Mutual Fund, LIC Mutual Fund and Canbank Mutual Fund in the month of Feb. 1991 are such kinds of funds. These funds provide direct deductions from taxable income up to a certain limit (Rs. 10, 000/- under Sec.80 CCB of Income Tax Act)

Mutual Fund Companies in India

The concept of mutual funds in India dates back to the year 1963. The era between 1963 and 1987 marked the existence of only one mutual fund company in India with Rs. 67bn assets under management (AUM), by the end of its monopoly era, the Unit Trust of India (UTI). By the end of the 80s decade, few other mutual fund companies in India took their position in mutual fund market.

The new entries of mutual fund companies in India were SBI Mutual Fund, Canbank Mutual Fund, Punjab National Bank Mutual Fund, Indian Bank Mutual Fund, Bank of India Mutual Fund.

The succeeding decade showed a new horizon in Indian mutual fund industry. By the end of 1993, the total AUM of the industry was Rs. 470.04 bn. The private sector funds started penetrating the fund families. In the same year the first Mutual Fund Regulations came into existence with re-registering all mutual funds except UTI. The regulations were further given a revised shape in 1996.

Kothari Pioneer was the first private sector mutual fund company in India which has now merged with Franklin Templeton. Just after ten years with private sector players penetration, the total assets rose up to Rs. 1218.05 bn. Today there are 33 mutual fund companies in India.

Types of Mutual Fund Schemes in India

Depending on their objectives, pattern of investment and returns etc, the Mutual Fund schemes in India can be classified into five broad categories:

1. Growth Funds
2. Income Funds
3. Growth & Income Funds
4. Tax Planning Schemes
5. Other Schemes

Let us take a quick view of the important features of these schemes as follows:

1. Growth Funds

- i) **Objective:** Generating substantial capital appreciation.
- ii) **Investment Pattern:** Nearly all in equity shares.
- iii) **Duration:** Seven years
- iv) **Investment Risk:** High risk in reinvestment schemes or normal risks of equity investment for periodic capital gains schemes.
- v) **Returns:** No assured return but high returns are expected,
- vi) **Liquidity:** No repurchase facility except at the end of the scheme,
- vii) Listing on stock exchanges after certain lock in period from the date of allotment
- viii) Transfer of Units is allowed
- ix) **Target Investors:** Individuals in higher tax brackets interested in getting higher gains to beat taxation.

Some Examples of Growth schemes

Scheme	Issued by
a) Master Share, Master Share Plus, Master Gain, UGS-200	Unit Trust of India
b) Magnum Express, Magnum Multiplier	SBI Mutual Fund
c) Canshare, Canstar Cap, Cangrowth, Canbonus	Canbank Mutual Fund
d) Ind Ratna, Ind Sagar, Ind Moti	Indbank Mutual Fund



Main Advantages

- a) Generally high returns due to capital gains.
- b) Easy liquidity due listing on stock exchanges and transferability as also bank loan facility
- c) Tax exemptions on income as also long-term capital gains

Disadvantages

High risk, No assured returns

2. Income Funds

- i) **Objective:** Assured minimum income and safety of capital
- ii) **Duration:** 5-7 years
- iii) **Investment Pattern:** Bulk (75-80%) of funds invested in fixed income securities like government bonds, company debentures, etc. and rest in equity shares,
- iv) **Investment Risk:** Absolute safety,
- (v) **Return:** 14.75% p.a. upwards-payable monthly or quarterly plus mid scheme bonus and end of the scheme appreciation (minimum 2%)
- (vi) **Liquidity:** No listing on stock exchanges and Units are not transferable. Repurchase facility after initial lock -in period of three years.

Bank loan facility upto 75% of the Unit's face value

Main Advantages

- a) Safety of investment and assured minimum income.
- b) Reasonable liquidity due to availability of bank loan facility
- c) Income / dividend eligible for exemption upto Rs. 10,000/- under section 80L of Income Tax Act.

Disadvantages

Extraordinary gains not possible.

Some Examples of Income Fund:

- | | |
|---|---------------------|
| a) Units Scheme of 1964, Growing Income Unit Scheme of 1987 | Unit Trust of India |
| b) Magnum Monthly Income Schemes | SBI Mutual Fund |
| c) Rising Monthly Income Scheme | BOI Mutual Fund |
| d) Swarna Pushpa | Indbank Mutual Fund |
| e) GIC Safe-1991, GIC-Rise-1991, Big Value. | GIC Mutual Fund |
| f) PNBRIPS | PNB Mutual Fund |



a) **Growth And Income Funds**

These are 'No Guaranteed Return' schemes of either all enquiry fund type or balanced fund type.

All Equity Fund Schemes

- i). **Objective** : High income combined with growth.
- ii). **Duration**: 7 years
- iii). **Investment Pattern**: Almost all in equity shares
- iv). **Investment Risk**: Risky investment Capital, value can go up or down.
- v). **Returns**: No assured return. Annual distribution of minimum 80% of the Trust's net income from dividends, interest etc. Good capital appreciation expected at the end of the scheme,
- (vi). **Liquidity**: No repurchase facility except at the end of the scheme

Listing on stock exchanges

Transfer of Units allowed

Bank loan upto 75% of the face value of Units allowed

Main Advantages

- (a) Good annual returns (though not assured) with good capital appreciation at the end of the scheme
- (b) Tax saving on capital gains

Some Examples of All Equity Funds

Scheme	Issued by
i). Canstock, Can double	Canbank Mutual Fund
ii). PNB Premium Plus- 91	PNB Mutual Fund

Balanced Funds

- 1. **Objective**: Income and growth with reasonable safety
- 2. **Duration**: seven years
- 3. **Investment Pattern**: About 50% in equity and the rest in debentures etc
- 4. **Returns**: No assured return, but steady income due to annual distribution of minimum of 80% of the Trust's income by way of dividends, interest etc.

Reasonably high capital appreciation also expected

- 5. **Liquidity**: Repurchase facility after initial lock-in period of three years



No listing on stock exchanges

Transfer of Units permitted

Units can be pledged to banks for loans

Main Advantages

- (a) Reasonable return with possibility of reasonable capital appreciation
- (b) Tax exemptions on income as well as capital gains

Some Examples of Balanced Funds

Scheme	Issued By
MRIS' 87,89,90	SBI Mutual Fund
Cancigo, Cangi	Canbank Mutual Fund

Tax Planning Schemes

The investments made under these schemes are deductible from the taxable income upto certain limits, thus providing substantial tax relief to the investors. **Examples of Tax Planning Schemes:**

- a) MTSS' 89, 90, 91 and Magnum GIFTS of Mutual Fund
- b) Can 80CC and Canstar 80L of Canbank Mutual Fund
- c) Ind 88A of Indbank Mutual Fund
(Here Tax rebate is available on investments as in the case of investments in LIC, Provident Fund, NSC, etc)
- d) Equity Linked Savings Schemes (ELSS)

MELS-91	SBI Mutual Fund
Can Pep-91,92	Canbank Mutual Fund
Ind Shelter	Indbank Mutual Fund
MEP-91,92	Unit Trust of India
BOINAANZA 80 CCB	BOI Mutual Fund
PNB ELSS	PNB Mutual Fund

ELSSs are 10-year schemes and the withdrawals (by purchase) are permitted after an initial lock-in period of three years but the entire withdrawn amount again becomes taxable. As such these are only tax deferent schemes.

Main Advantages

- i. Substantial tax saving / deferment
- ii. Possibility of reasonable capital gains

Main disadvantages

- i. No liquidity during lock in period

- ii. Withdrawn amounts are again taxable
- iii. Units are not transferable

Other Schemes:

These include schemes of 10-15 years duration, which offer multiple benefits. For example:

	Scheme	Benefits
a)	Unit Linked Insurance Plan of UTI	i. Contribution eligible for tax deduction under Sec 88-A of IT Act providing tax rebate of 20% of Contribution
		ii. Insurance Cover upto target amount
		iii. Reasonable income by way of dividend
		iv. Liquidity: withdrawal from the scheme any time on a Month's notice permitted
		v. Safety of capital
b)	Dhanaraksha, Dhansahyog Dhanavirdhhi	These offer some or all of the following benefits:
	Schemes of LIC Mutual Fund	i. Life Insurance cover
		ii. Accident insurance cover
		iii. Reinvestment of annual dividends or reasonable dividend
		iv. Safety of capital
		v. Reasonable capital appreciation
		vi. Liquidity: repurchase facility after initial lock-in period of three years.
		vii. Units are not transferable but bank loan facility is available
		viii. Tax exemption on dividends under section 80L and tax benefits under long term capital gains are available



Other Categories

Sector Specific Schemes These are the funds/schemes which invest in the securities of only those sectors or industries as specified in the offer documents e.g. Pharmaceuticals, Software, Fast Moving Consumer Goods (FMCG), Petroleum stocks, etc.

Tax Saving Schemes These schemes offer tax rebates to the investors under specific provisions of the Income-tax Act, 1961 as the Government offers tax incentives for investment in specified avenues e.g. Equity Linked Savings Schemes (ELSS).

Off-Shore Funds These funds will have non-residential investors and are regulated by the provision of the foreign countries where these are registered. Further, these funds are governed by the rules and procedures laid down for the purpose of approving and monitoring their performance by the Department of Economic Affairs, Ministry of Finance and the directions of RBI.

Asset Management Mutual Funds These are also called Asset Management Companies (AMCs). These have special characteristics of dealing with assets other than securities. These funds can acquire various assets and give them on lease basis to needy lessees.

Net Asset Value

NAV is calculated as follows:

$$\text{NAV} = \frac{\text{Fair market value of Scheme's Investments} + \text{Receivables} + \text{Accrued income} + \text{Other assets} - \text{Accrued expenses} - \text{Payables} - \text{Other liabilities}}{\text{Number of units outstanding}}$$

Entry Load and Exit Load

A Load Fund is one that charges a percentage of NAV for entry or exit. That is, each time one buys or sells units in the fund, a charge will be payable. This charge is used by the mutual fund for marketing and distribution expenses.

Calculation of Front-end Load or Entry Load

$$\text{Public Offer Price} = \frac{\text{Net Asset Value}}{1 - \text{Front-end Load}}$$

Calculation of Back-end Load or Exit Load

$$\text{Redemption Price} = \frac{\text{Net Asset Value}}{1 - \text{Back-end Load}}$$

Return on Investment

The investor who invests in mutual fund units can receive returns in the following two ways:

- Capital Appreciation - Profit earned on sale of units at a higher NAV than the original cost.
- Income Distribution - When a fund makes a profit on its investment, this (dividend) profit will be given to investor as a dividend which can be re-invested in the fund or retain it in the form of cash.

$$r = \frac{(NAV_t - NAV_{t-1}) + I_t + G_t}{NAV_{t-1}}$$

Where r = Return on mutual fund
 NAV_t = Net asset value at the time period 't'
 NAV_{t-1} = Net asset value at time period "t-1"
 I_t = Income at time period 't'
 G_t = Capital gain distribution at time period 't'

Required Return on Mutual Fund Investment (as a percentage)

$$R_2 = \left[\frac{1}{1 - \text{Initial expenses}(\%)} \times R_1 \right] + \text{Rcurring expenses}(\%)$$

Where, R_1 = Personal Return of investor

R_2 = Mutual Fund earnings

Effective Yield on Mutual Fund Investment

$$= \frac{\text{Dividend} + \text{Capital Appreciation}}{\text{Initial Investment}} \times \frac{365}{\text{No. of days}} \times 100$$

Illustration 1

A mutual fund that had a net asset value of Rs. 10 at the beginning of month 1 made income and capital gain distribution of Re.0.05 and Re.0.04 per share respectively during the month, and then ended the month with a net asset value of Rs. 10.03. Calculate monthly return.

Solutions;

Monthly Return on the Mutual Fund

$$r = \frac{(NAV_t - NAV_{t-1}) + I_t + G_t}{NAV_{t-1}}$$

Where r = Return on mutual fund

NAV_t = Net asset value at the time period 't' i.e. Rs.10.03

NAV_{t-1} = Net asset value at time period "t-1" i.e. Rs.10.00

I_t = Income at time period 't' i.e. Rs. 0.05

G_t = Capital gain distribution at time period 't' i.e Rs. 0.04

By substituting, we get



$$r = \frac{(\text{Rs } 10.03 - \text{Rs } 10.00) + \text{Re } 0.05 + \text{Re } 0.04}{\text{Rs } 10.00} = 0.012$$
$$= 1.20\% \text{ p.m. or } 14.4\% \text{ p.a.}$$

Illustration 2

The unit price of RSS Scheme of a mutual fund is Rs. 10. The public offer price (POP) of the unit is Rs. 10.204 and the redemption price is Rs. 9.80. Calculate: (i) Front-end load, and (ii) Back-end load.

Solution;

(i) Calculation of Front-end load

$$\text{Public offer price} = \frac{\text{Net asset value}}{1 - \text{Front-end load}}$$

Where, Public offer price Rs. 10.204; Net asset value Rs. 10.

$$10.204 = \frac{10}{(1 - F)}$$

$$10.204 (1 - F) = 10$$

$$10.204 - 10.204 F = 10$$

$$10.204 F = 10.204 - 10$$

$$F = 0.204 / 10.204 = 0.01999$$

$$\therefore \text{Front-end load} = 2\%$$

(ii) Calculation of Back-end load (B)

$$\text{Redemption price} = \frac{\text{Net asset value}}{1 - \text{Back-end load}}$$

$$9.80 = \frac{10}{(1 - B)}$$

$$9.80 (1 - B) = 10$$

$$9.80 - 9.80 B = 10$$

$$-9.80 B = 10 - 9.80$$

$$B = 0.20 / 9.80 = 2.04\%$$

$$\therefore \text{Back-end load} = 2.04\%$$

Illustration 3

Mr. Raja can earn a return of 16 per cent by investing in equity shares on his own. Now he is considering a recently announced equity based mutual fund scheme in which initial expenses are 5.5 per cent and annual recurring expenses are 1.5 per cent. How much should the mutual fund earn to provide Mr. A, a return of 16 per cent ?

Solutions:

$$R_2 = \left[\frac{1}{1 - \text{Initial Expenses}(\%)} R_1 \right] + \text{Recurring Expenses}(\%)$$

Where,

Personal earnings of Mr. A = R_1

Mutual Fund earnings = R_2

$$= \left[\frac{1}{1 - 0.055} \times 16\% \right] + 1.5\% = 18.43\%$$

$\therefore$ Mutual Fund Earnings = 18.43

Illustration 5

RKV has invested in three Mutual Fund Schemes as per detailed below :

	MF X	MF Y	MF Z
Date of investment	01-12-2006	01-01-2007	01-03-2007
Amount of investment	Rs. 50,000	Rs. 1,00,000	Rs. 50,000
Net Asset Value (NAV) at entry date	Rs. 10.50	Rs. 10	Rs. 10
Dividend received upto 31-03-2007	Rs. 950	Rs. 1,500	Nil
NAV as at 31-03-2007	Rs. 10.40	Rs. 10.10	Rs. 9.80

What is the effective yield on per annum basis in respect of each of the three schemes to Mr. RKV upto 31-03-2007 ?

Solutions;

Calculation of effective yield on per annum basis in respect of three mutual fund schemes to Mr. RKV upto 31-3-2007

Particulars	M F X	M F Y	M F Z
(a) Investment (Rs.)	50,000	1,00,000	50,000
(b) No. of units	4,761.905	10,000	5,000
(c) Unit N A V on 31-3-2007 (Rs.)	10.40	10.10	9.80
(d) Total N A V on 31-3-2007 (b) X (c) (Rs.)	49,523.81	1,01,000	49,000
(e) Increase (Decrease) of N A V (a)-(d) (Rs.)	(476.19)	- 1,000	(1,000)
(f) Dividend Received (Rs.)	950	1,500	Nil
(g) Total yield (e)+(f) (Rs.)	473.81	2,500	(1,000)
(h) Number of days	122	91	31
(i) Effective yield p.a. (%)	2.835%	10.027%	(-) 24%

Creation of a Portfolio

The portfolio of a mutual fund depends on the objectives of each scheme/fund floated by mutual fund. For example, the objective of an income oriented scheme is to provide regular monthly income to its shareholders. The portfolio of such a fund should consist of fixed income bearing securities so that the fund can achieve its objective. It has been learnt from Indian experience that the portfolio of such a fund consists of mainly the following securities:

- Non Convertible Debentures (NCD's) - 75 to 90%
- Call Money-10 to 25%

A portfolio of income cum growth oriented fund consists of mainly NCD's upto 70% of the portfolio, approximately 25% of equities and 5% of money market instruments. On the other hand, a pure growth of equity fund creates a portfolio of share/stock of growth or blue-chip companies.

The fund manager of a mutual fund is the person responsible for buying these securities in such a way that the fund is able to achieve its objectives. A fund manager tries to create a well-diversified portfolio of securities so that unsystematic risk is reduced significantly and returns expected on individual securities and on portfolio is directly related to 'market risk' or systematic risk. A fund manager has the following investment options in terms of buying securities from the Indian market:

Securities	Returns
1 Call Money Average returns	15%
2 Bills	13 to 14%
3 Treasury Bills	10%
4 Govt. Bonds	11.5%
5 Public Sector Bonds	13%
6 Company Debentures	15% to 16.5% (yield to maturity)
7 Dividend / Return on equity shares	2-3%
8 Capital Gains	Uncertain

The expected returns from a mutual fund are higher than what is provided by bills, treasury bills, Govt. or P. S. bonds. Hence mutual funds concentrate on NCD's, equities and to some extent call money which provide good returns along with liquidity. While buying these securities, the fund manager takes into consideration the following norms for each kind of security.

Non-convertible Debentures

i) Asset Cover or Security Cover:

A company must maintain a minimum asset cover. This cover is calculated on the basis of secured borrowings and debentures charged to fixed assets, whereby fixed assets should be in general more than one time of the total such existing borrowings and debentures secured by equitable mortgage on fixed assets. The movable fixed assets are generally excluded from the calculations.

ii) Interest Cover:

PBIDT (profit before interest, depreciation and taxes) should be around two times the existing interest liability plus the interest liability on the proposed debentures so as to protect the payment of interest on the debentures. This cover is to be calculated on the basis of the average of the preceeding three years profit figures.

iii) Company must have paid dividend for the last three or minimum two preceeding years.

iv) Net worth of the company should be around Rs. One Crore.

Small variations in the above norms are accepted provided the company is otherwise very sound and the rate of return is higher than normal.

Portfolio Revision

There are two broad aspects of portfolio management, namely, effective investment planning and constant review and revision of Investment.



While we have already discussed the first aspect under 16.6, let us discuss the second aspect hereunder.

Constant review and revision of investment requires:

- i) Continuous monitoring of the quality management of the companies in which investment has already been made.
- ii) Continuous financial analysis and trend analysis of the companies' balance sheets / profit and loss account to choose sound companies and off-load investment made in companies where the performance is slackening.
- iii) Continuous analysis of the securities market trends.

Systems and Controls

For managing a portfolio, it is not only the creation, re-creating and regrouping of various securities which is important for achieving the desired rate of return, but various kinds of systems and controls are needed. A Mutual Fund generally provides the desired controls through its accounting and custodian system. We shall discuss each of them and how these help to manage a portfolio.

Accounting system

An accounting system must clearly disclose:

- i) The policy in respect of recognition of revenue and income from investment,
- ii) The policies relating to valuation of investments.
- iii) The aggregate carrying value and market value of non performing assets under each type of investment,
- iv) Provision to be made for depreciation / loss in the value of non performing investments,
- v) Per unit Net Asset Value (NAV) at various intervals and at the end of the accounting year.

All the above accounting policies if pursued consistently help to maintain a clear picture about all investments in a portfolio and thus provide the true picture of the portfolio.

Summary

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realised are shared by its unit holders in proportion to the number of units owned by them. Thus a Mutual Fund is the most suitable investment for the common man as it offers an opportunity to invest in a diversified, professionally managed basket of securities at a relatively low cost. The flow chart below describes broadly the working of a mutual fund:

Mutual Funds have proved to be an attractive investment for many investors, the world over, since they give them a mixture of liquidity, return and safety in accordance with their performance. Further, the investor gets these benefits without having to directly a diversified portfolio, which is handled by specialists. The interest of various investors are generally protected



through mutual funds. As individual investors they may not hold much clout in companies whose shares they hold but by being part of institutional investors like mutual funds, their bargaining power is enhanced.

The portfolio of a mutual fund depends on the objectives of each scheme/fund floated by mutual fund. For example, the objective of an income oriented scheme is to provide regular monthly income to its shareholders. The portfolio of such a fund should consist of fixed income bearing securities so that the fund can achieve its objective.

Key Words

- Mutual fund
- Open ended
- Closed ended
- Growth Schemes
- Income Schemes
- Balanced Schemes
- Money Market Schemes

Short Questions

1. Write a brief note on Concept of Mutual Fund
2. Explain Mutual Fund Operation showing the Flow Chart
3. Write on the History of Mutual Funds Industry in India
4. How does the Mutual Funds Organisation function?
5. What are the advantages of Investing in Mutual Funds
6. Is there any drawbacks of Mutual Funds in India? if yes what are the drawbacks? And how to improve the same?
7. What are the different types of mutual funds schemes? Explain one by one with examples
8. Write a short note on
 - a. Open - Ended Schemes
 - b. Close - Ended Schemes
 - c. Interval Schemes
9. Explain with example mutual fund schemes based on Investment Objective
 - a. Growth Schemes
 - b. Income Schemes
 - c. Balanced Schemes
 - d. Money Market Schemes



10. Write a note on Tax Saving Schemes , Special Schemes, Index Schemes , Sector Specific Schemes
11. What do you mean by Creation of a Portfolio
12. Explain Portfolio Revision

Objective Questions:

1. The investors by investing in the Mutual Funds get the benefit of (Potential of Returns ; Diversified portfolio ; Flexibility ; All the above)
2. The Mutual Funds that are listed in the stock Exchanges are (Growth schemes ; Closed – End Scheme ; Open –End Scheme)
3. An aggressive portfolio consists of bonds : stock in the ratio of (a. 10 : 90 ; b. 60 : 40 ; c. 50:50)
4. The NSE Nifty Index Fund consists of (90% of stocks of the Index ; All stocks of the Index ; Stocks of High Market Capitalization in NSE)
5. Investment in a mix of equity and debt instruments (Hybrid scheme ; Index scheme ; Sectoral Scheme)
6. A hybrid of a closed- ended index fund and an open-ended index fund. (Diversified equity scheme ; Index scheme ; Exchange Traded Fund)
7. The investor has the choice of investing regular sums of money every month to buy units of a mutual fund scheme resorting to 'Rupee cost Averaging'. (Systematic Investment Plan ; Money Market Scheme ; Closed-Ended Scheme)
8. Security selection involves a search for under-priced securities employing fundamental And/ or technical analysis, to identify stocks which seem to promise superior returns.(Passive Portfolio strategy ; Active Portfolio Strategy ; Portfolio Rebalancing Strategy)
9. _____ measures the difference between a Mutual fund's actual and expected returns. (Beta factor ; Alpha factor ; Net Asset Value)
10. The Return on Mutual Fund is computed from the formula.

(a. $\frac{(NAV_t - NAV_{t-1}) + 1_t + G_t}{NAV_{t-1}}$;

b. $\frac{(NAV_{t-1} - NAV_t) + 1_t + G_t}{NAV_{t-1}}$

c. $\frac{(NAV_t - NAV_{t-1}) + G_t - 1}{NAV_t}$)

[Answers: 1. d ; 2. b ; 3. a ; 4. b ; 5. a ; 6. c ; 7. a ; 8.b ; 9.a ; 10. a]



Problems:

1. You can earn a return of 16 percent by investing in equity shares on your own. You are considering a recently announced equity mutual fund scheme where the initial issue expenses are 6 percent and the recurring annual expenses are expected to be 1.5 percent. How much should the mutual fund scheme earn to provide a return of 16 percent to you?
2. You can earn a return of 14 percent by investing in equity shares on your own. You are considering a recently announced equity mutual fund scheme where the initial issue expenses are 4 percent and the recurring annual expenses are expected to be 2.6 percent. How much should the mutual fund scheme earn to provide a return of 14 percent to you?
3. You can earn a return of 16 percent by investing in equity shares on your own. You are considering a recently announced equity mutual fund scheme where the initial issue expenses are 8 percent. You believe that the mutual fund scheme will earn 18.4 percent. At what recurring expense (in percentage terms) will you be indifferent between investing on your own and investing through mutual fund. (Ignore other costs).

Suggested Further Readings

1. **Security Analysis and Portfolio Management - Sudhindra Bhat - Excel Books Publication, New Delhi**
 2. **Security Analysis & Portfolio Management - Fischer & Jordan - Prentice - Hall of India Private Limited**
 3. **Investment Analysis & Portfolio Management - Prasanna Chandra - Tata Mc Graw - Hill Publishing Company Limited**
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