# In public interest only

***Serious regulation is needed to discourage mutual funds from pandering to the whims of corporates, ignoring small investors in the process***

***Funds are a vehicle for the small investor, but corporates hold 65 per cent of their assets***

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Websites of regulators and financial organisations across the world reveal common definitions for a mutual fund: "a security that gives small investors access to a well-diversified portfolio of capital market instruments". Note the emphasis on the small investors.

Mutual funds are investment vehicles for the 'little guy'. In US, around 92.3 million individuals hold 47 per cent of their financial assets in them. Small investors own 77 per cent of fund assets (8,606 funds had a combined asset base of $9.2 trillion as of April 2006). Fiduciaries like banks and individuals serving as trustees, guardians, administrators, or bank nominees hold 13 per cent, while other institutional investors hold 10 per cent.

**Corporate bias**

Indian mutual funds haven't been as responsive to small investor and are yet to emerge as a significant asset class for him. In 2004-05, only 1.4 per cent of household savings got allocated to the capital market, including mutual funds.

The reason: increasing 'corporatisation' of the mutual fund industry. Though no data has been made public, it is believed corporates hold 65 per cent of fund assets. In fact, several schemes had just one or a handful of investors (corporates), until Sebi banned this practice.

Why this obsession with corporates? They help increase a fund's assets under management, leading to better bonuses for managers, improved fund rankings and lower transaction costs. Ironically, many funds have been sponsored by corporates themselves, creating a conflict of interest.

Corporates can flex their money muscle to get units at nil loads and influence investment decisions. They've also been known to use funds to prop up the their own stocks.

Corporates also do not offer stability to funds -- the're the first to redeem both in normal times and in a crisis.

The result: Funds, wanting to keep corporate happy, spend more time on them. Every fund, though, wants more 'hassle-free' retail investors. But to get them, funds mislead them into buying NFOs 'at par' and lure them through passbacks, only to dump them with a greater share of expenses, and poor after sales service.

**Stemming the rot**

It's time to take a relook at the philosophy of the industry.
The remedy lies in discouraging corporates from participating in mutual funds. This can be done by putting a cap of say, Rs 5-10 lakhs per investor per scheme or by creating tax disincentives. Another way is to cap total corporate investments in any scheme at say, 10 per cent. The concept is already in practice in the capital market, which prescribes a minimum public holding requirement. Moreover, in IPOs, corporates can subscribe to a maximum of 15 per cent in the high net wroth individual (HNI) quota. And there is a cap on FII investments in specified stocks. In mutual funds, the cap would have to be prescribed both at the NFO and the post-NFO level. The time and effort spent on corporates would then be available to the small investor.

This is not to banish corporates from equities. The IPO and secondary market will still be available to them. Corporates, in any case, are informed investors. If they still need external assistance, they should engage portfolio managers. They should not be allowed to use mutual funds for treasury operations. If at all corporates are to be allowed to invest in mutual funds, special vehicles should be set up for them.

At the same time, fund houses have to show more respect to small investors by charging them less, educating them, being more transparent and investor-friendly and responding to their grievances on priority. The industry should realise that small investors are typically uncertain about the timing and merits of redemption, and therefore turn out to represent longer-term money.

The issue of the high sales commissions mutual funds offer also need to be addressed. High commissions represent a conflict of interest, as they benefit the sales force, but hurt investors. Besides, they cause sales people to sell funds that max their incomes, but are unsuitable to investors.

Mutual funds have become so large in the US with small money that they now not only play a key role in mopping up household savings, but also foster good governance in the companies they invest in.

In India, mutual funds are still in the periphery on all these areas. They are yet to emerge as a counter force to FII in the market. Regulatory intervention is required for this to happen. Sebi can mandate a new policy compelling mutual funds to re-orient their objectives. In the long run, this will not only benefit them but also the retail investors and the economy.