Mutual Fund Mystery*

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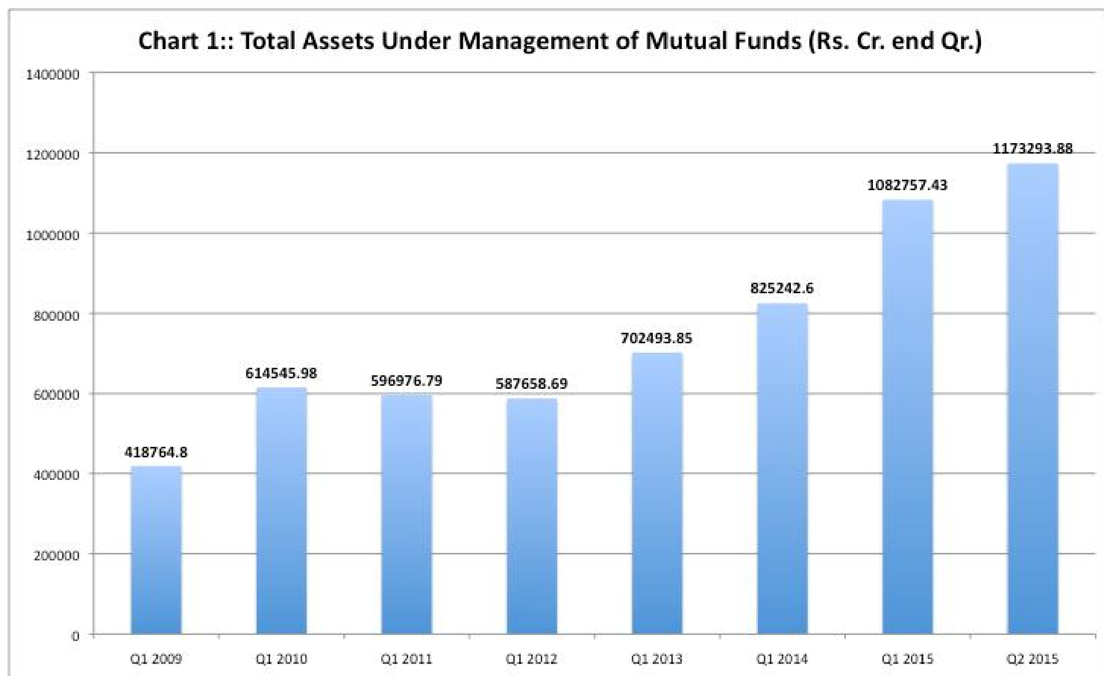
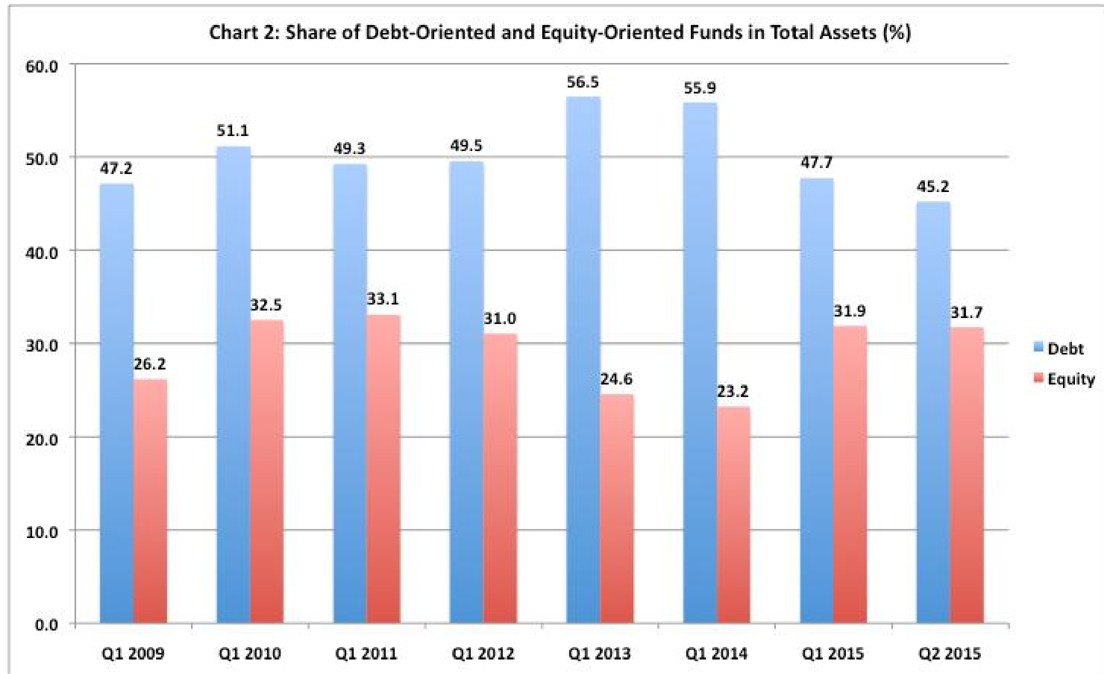
The mutual fund industry is experiencing a boom, with investors pouring in resources to expand the assets it manages. If we consider data for the first quarter of each year since end-March 2009, Assets under Management (AUM) of mutual funds, which were stagnating in the Rs 5,88,000 crore to Rs 6,15,000 crore range until end-March 2012, subsequently registered a sharp increase to touch Rs10,83,000 crore at the end of March 2015 and then rose to Rs 11,73,000 crore in the quarter ending 30 June 2015 (Chart 1). Since retail investors are the dominant investors in equity-oriented mutual funds, this evidence is being used to argue that such investors are rushing into equity markets via the mutual fund route.



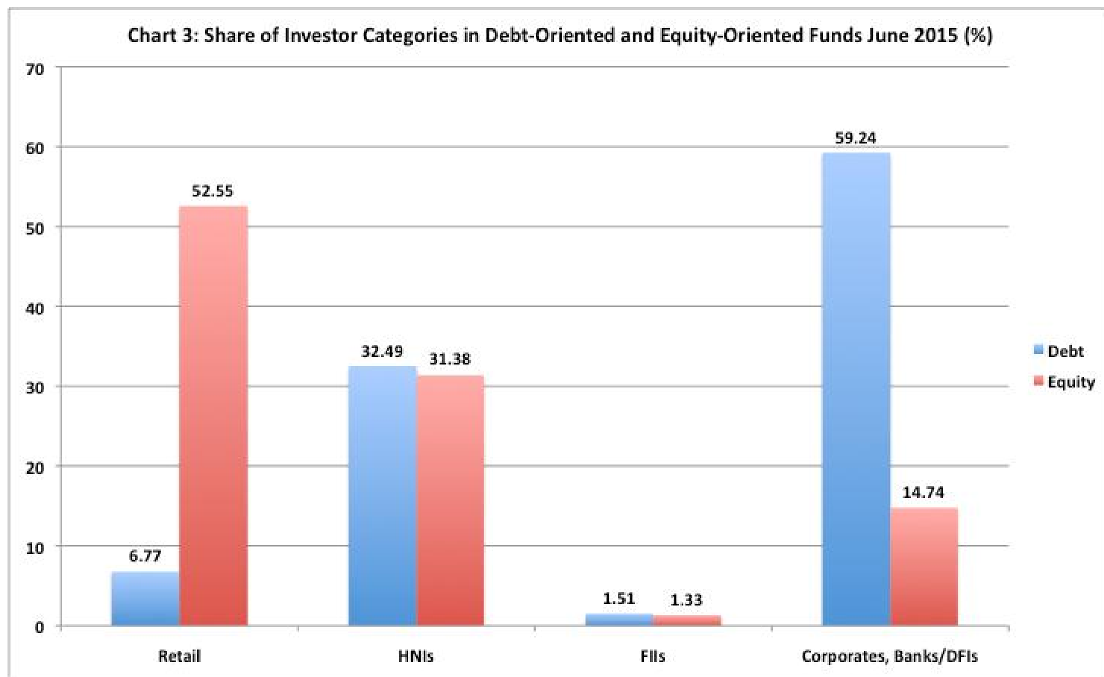
This trend is, however, recent and new. Although the number of mutual funds has risen sharply since 1986-87 (before which the only one in existence was the Unit Trust of India) and private funds were allowed entry in 1993, there was only a small increase in funds mobilisation by mutual funds during the 1990s. Mutual fund activity got a substantial boost only in the years since 2003-04, when stock market activity picked up significantly and the market was generally buoyant. But even after 2004, there has been much volatility in the resources mobilized by mutual funds net of redemptions, with the figure being negative in at least three years of the past decade.

Even the surge in activity in the very recent period cannot be automatically attributed to enhanced retail investor presence. This is because a significant proportion of the funds mobilised by mutual funds flows into debt-oriented funds, whose share peaked at 56.5 per cent in the first quarter of 2013, and only declined from around that level over the year ending March 2015 to 47.7 per cent and then further to 45.2 per cent over the next quarter (Chart 2). On the other hand, in the post-March 2011 period, equity-oriented mutual funds saw their shares in total AUM initially decline, from 33.1 per cent to as low as 23.2 per cent at the end of the first quarter of 2014. And though such funds recorded a rise in share since then, they are still slightly short of

their end-March 2011 levels. (Balanced Funds, which combine debt and equity and through which investors obtain some equity exposure, have recorded consistently a low share of less than 3 per cent). In sum, though debt funds have lost some ground, they still command the dominant share. The gains of equity-oriented funds are very recent and they are yet to regain their previous peak in terms of share in AUM.



These trends are significant because debt oriented funds are dominantly held by corporates, whereas equity-oriented funds are dominantly held by retail investors (Chart 3). Corporates, banks and domestic financial institutions (DFIs) accounted for 59 per cent of the AUM in debt-funds in the quarter ended June 2015. High Networth Investors (HNIs, with investments exceeding Rs 5 lakh) accounted for another 31 per cent, whereas "actual" retail investors held just 7 per cent. FIIs showed little interest with a 1.5 per cent share. In the case of equity-oriented funds, on the other hand, the corresponding shares were 15 per cent (for corporates and DFIs), 32 per cent (HNIs), 53 per cent (retail investors) and 1.3 per cent (FIIs). These stark differences in the holding pattern notwithstanding, the overall increase in the AUM under mutual funds has meant that assets managed under debt funds have risen from Rs 1,61,000 crore at the end of September 2012 to Rs 3,14,000 crore at the end of June 2015, and those under equity funds from Rs 1,27,000 crore to Rs 1,96,000 crore. However, it is worth noting that in the case of retail investors, almost all of the increase was very recent and came after September 2014.



This very recent increase in retail investor interest in equity expressed through the mutual fund route is surprising. Between April and August 2015, while corporate performance was weak and expectations of performance depressed, investors (possibly in response to falling gold prices and depressed real estate markets) had been putting their savings into equity mutual funds, which in turn were investing that money in the stock market. Between March and July 2015, investors have poured in Rs 45,127 crore into equity mutual funds. As a result, over April to August, equity mutual funds had invested Rs 39,205 crore in the stock market, whereas Foreign Institutional Investors, who have been driving the stock market for the last few years, had been net sellers and sold stocks to the tune of Rs 8,950 crore during those months. This could imply that retail investors are entering the market at a time when they are likely to make losses.

There has been evidence in the past too that retail investors directly entering the secondary market seem to suffer losses on average. A study by Sankar De, Naveen R. Gandhi and Subrata Sarkar (2011) of the Indian School of Business, using a database covering transactions of all 755 stocks traded on the NSE between January 1, 2005 and June 30, 2006, found (i) that retail investors incurred losses over that period, with trading losses alone placed at Rs 8,376 crore, and losses including commissions, transactions taxes, etc estimated at Rs 20,700 crore; and (ii) that this was the result of two significant biases, termed the ‘disposition effect’ and ‘overconfidence effect’.

The ‘disposition effect’ is reflected in the tendency for investors to sell assets in which they have registered gains and hold assets in which they are making losses, in the hope that they would register profits in time. This tendency is reinforced by the ‘overconfidence effect’, reflected in the tendency to recognise gains and feel proud about successful trades, but ignore losses and believe that holding on to a loss-making stock would eventually result in gains, once the distortions that neutralised expected gains disappear.

If retail investors are rational, it should be expected that in the wake of such experiences they would withdraw from equity markets and alter their behaviour when

they return. What the recent evidence suggests is that this does not seem to have happened. The only change is that they are relying more on mutual funds to access the market. Moreover, the evidence suggests that rather than serve as a check on irrational investing by retail investors, mutual funds benefit from any spike in retail investor activity to increase their assets under management (AUM) and their own revenues.

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