Analysis of the reasons For a mutual fund to get promoted and recommended by the distributors

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Comments by the Faculty

With the growing disposable income of the burgeoning middle class in India, the propensity to both save and spend has increased. Investing in share markets not only yields dividends but also capital appreciation. But unfortunately, share markets are subject to volatility and more often than not, the small retail investors who have no technical knowledge, tend to lose out than gain in the share market. This is where the Mutual Funds (MF), which are managed by financial experts, serve the objective of the investors in reaping a reasonable returns on their investments while "minimising" the risks. However, it must be appreciated that investments in MF are also subject to "market risk" but investors will be able to reduce this risk by preferring good mutual fund operators.

Mutual fund market is highly competitive and smaller companies such as JM Financials Asset Management Company (AMC) are finding it difficult to retain their foothold in the market. Thus, it becomes imperative for such companies to explore the reasons as to why a particular mutual fund gets promoted and recommended by the distributors.

This paper is a documentation of the work carried out by Mr Deepak Semwal, a student of PGDM 2011-13 batch, who carried out Summer Internship under my guidance at JM Financials AMC. The paper analyses the reason which prompt the dealers to promote and recommend a particular mutual fund. With the abolition of "entry load" on the mutual funds, dealers have to depend on "Upfront Fee" and "Trail Commissions" and the study establishes that the trail commission paid determines the mutual fund that is promoted and recommended. The study determines that the commission paid by JM Financial AMC is low (1.6%) as compared to the industry standards (2%) but is marginally higher than the commission paid by companies like ING Investments (1%). So, common sense would indicate that it is desirable to increase the commission to motivate the dealers. But increasing the commission is a double edged sword which, while increasing the motivation level of the distributors, can cut into the profit of the JM Financials!

The study, therefore, recommends that while the commissions have to be increased, JM Financials has decrease the “Management Fee” if the performance of the management team is not satisfactory thus balancing the twin objectives of survival and profitability.The study gains importance with the mutual fund industry becoming hyper-competitive and suitable strategies have to be drawn for survival and success. With the advent of internet and other sources of ready information, the general awareness among investors has increased and this calls for more transparency in fund management. These investors demand best performing fund from his/her advisors. This calls for a more prudent management of mutual funds.The Indian mutual fund industry has immense growth potential, and if aided well by technological advancements and increased awareness, MFs can be a major contributor to the overall Indian economy. The industry has moved from the asset gathering mandate to asset managing mandate. It is recommended that investor Awareness programs should be conducted more regularly, say once in three months, especially in semi-urban area which are largely untapped.

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Analysis of the reasons for a mutual fund to get promoted and recommended by the distributors

Introduction

Mutual funds are a very attractive class of investment vehicle for investors. Investors can get advantage of professional management and diversification to minimize risk involved. But the situation is not all hunky-dory for thousands of mutual fund distributors. Total assets under management have decreased by 6.83% compared to 2011 which indicates a reduction of more than Rs. 50,000 crore in a year alone (NSE-2012). This also means that big fund houses in the country are competing intensely for capturing market share. There are 44 fund houses operating in the domestic mutual fund space, managing assets worth Rs 6.92 lakh crore. More than half of the assets are controlled by the sector's top five players — HDFC Mutual Fund, Reliance Mutual Fund, ICICI Prudential, Birla Sun Life and UTI AMC (Business Standard). Even so, top distributors are able to collect generous commissions because of sheer scale of funds they sell, but small distributors are not so lucky and facing problems to sustain business. The paper is an attempt to know the reasons for fund recommendation by small distributors and offer suggestions to JM Financial to improve its standing in the fiercely competitive market. The author had the privilege of studying this problem in the year 2012 as a part of summer internship project. This paper is a formal documentation of the work pursued.

JM Financial AMC

JM Financial Mutual Fund is one of India's first private sector mutual funds-an integral part of the first wave that commenced operations in 1993-94. JM Financial & Investment Consultancy Services was founded on September 15, 1973. JM Financial Asset Management Company (AMC) Private Limited started operations in December 1994 with a simultaneous launch of three funds-JM Liquid Fund (now JM Income Fund), JM Equity Fund and JM Balanced Fund. Today, JM Financial Mutual Fund offers a bouquet of funds that caters to the diverse needs of both its institutional and individual investors. It believes to cultivate investor loyalty, provide a safe haven for investments. The company aspires to help investors realize their investment goals through prudent advice, judicious fund management, impeccable research, and strong systems of managing risk scientifically (JM Financial, 2012).

Objectives of the Study

JM financial operates in a highly competitive mutual fund industry and aspires to be the market leader in terms of Asset Under Management (AUM). It faces stiff competition from the stable players like HDFC Mutual Fund, Reliance Mutual Fund, ICICI Prudential, Birla Sun Life and UTI AMC. Currently, JM financial has average AUM of Rs. 5811.94 crore compared to a total of Rs. 692 lakh crore for the industry. This works out to JM Financials market share at 0.001%. Also 85.13% of (Asset under Management) AUM comes from top 5 cities, with only 5% from tier-II cities. Author has also noticed that the presence of JM Financial AMC in small towns is negligible (JMFINANCIAL-AUM_REPORT).

This led us to believe that the problem lies in company's operations. Hence, main objectives of the study are:–

- To identify the reasons for comparatively low market share with respect to other leading players in the industry.
- To identify the reasons for scoring low in recommendation from small distributors in comparison to other players in the market.
- To develop viable solutions and suggestions to increase market penetration and market share.

This paper is documentation of the said work.

Performance, Operations of JM Financial

The Company has appointed 359 distributors around the country with JM Financial Securities Pvt. Ltd. being the largest distributor. The distributor was paid Rs. 133.33 lakh as brokerage in FY 2010-11. Other large distributors are ABN Amro Bank, Bajaj Capital Ltd., HDFC Bank Ltd. etc (JMFinancial-Brokerage).

With the abolition of entry loads in 2009, the net commission towards brokers has reduced sharply and they now have to depend solely on "Upfront Fee" and "Trail Commissions". The entry load was to the extent of 2.5% which was levied on investors. Abolition of entry loads on equity mutual fund schemes has sharply hit sales of equity schemes in the very first month of the new rule coming into effect. Around 80-90% drop in the equity assets can be attributed to the scrapping of entry loads, as independent financial advisors (IFAs) did not sell equity products in August, 2009.

(Economic-Times). Hence it is seen that small distributors have inclined towards other products such as insurance and high brokerage paying funds after the abolition of entry loads.

The brokerage, commission and performance of Company's funds are studied in this paper.

Research Methodology

The type of research that has been taken up is primary research. This was done to get familiarity with the general perception of distributors towards Company's products. The author has personally interacted with distributors to collect data and information. The distributors chosen were small and dependent on brokerages and commissions received on selling financial products. The methodology used for selecting the samples was convenience sampling. The sample size was 10 and encompassed every small and medium sized distributor across the city.

Data analysis and Discussions

Analysis was carried out after interacting with distributors. Simple statistical tools such as percentage, mean were applied using "Microsoft Excel". Analysis of data shows that there existed many factors upon which fund recommendation by distributor depended. Important factors are Commissions paid and performance of a particular fund. With the abolition of entry loads, Distributors' commissions are limited to upfront fee and this has caused in slowing down of fund inflow in equity funds.

There are two Kinds of Commissions Received by Distributor:

Upfront Fee – Upfront commission is the commission paid by AMC (mutual funds Company) to agent in the first year. The commission varies from one AMC to another and varies across different categories of mutual funds.

Trail Commission –This is most important part of commissions and main earning of mutual funds agents in long run. Trail commission is the commission paid to agents by AMC in subsequent years. This is paid on net worth of investments made by the client. (Association of Mutual Funds in India, 2012)

Commissions and brokerages are a major incentive for distributor especially independent financial advisors to sell a particular fund. A volatile market with uncertain market sentiments has added insult to the injury. The company paid around 1% as upfront fee and 0.6% as trail commission on an average for the period (Indicative values). The author has compiled data for various other leading players and it is presented as a Table-1.

Table 1: Indicative average upfront fee and trail commissions by major mutual funds

Mutual Fund Company	Asset Class	Upfront Fee (Percentage) (Annual %)	Trail Commission	TOTAL
Canara Robeco	Equity	1.00	0.80	1.80
Fidelity Mutual funds	Equity	1.50	0.75	2.25
ING Investment	Equity	0.50	0.50	1.00
JM Financial	equity	1.00	0.60	1.60
Reliance Capital	Equtiy	2.00	0.40	2.40
Principal Pnb	Equity	1.75	0.40	2.15
Franklin Templeton	Equity	1.80	0.20	2.00

The Company (JM Financials) has paid relatively low brokerage (1.6%) compared to other players in the market. The Company needs to revise its brokerage rates to increase the market share and add new distributors which will help it to increase market penetration.

The data shown above is for retail investors. The company charged lower brokerage from institutional investors because of huge investments made by them. This is represented in Table-2.

Table 2 : Existing and Revised fee structure

JM High Liquidity Fund

	Existing Structure			Revised Structure		
Expense Structure %	Regular Plan	Institutional Plan	Super Institutional Plan	Regular Plan	Institutional Plan	Super Institutional Plan
Management fee	0.38%	0.28%	0.18%	0.38%	0.28%	0.15%
Trusteeship fee	0.05%	0.05%	0.05%	0.05%	0.05%	0.05%
Other fee	0.07%	0.07%	0.07%	0.07%	0.07%	0.07%
Total	**0.50%**	**0.40%**	**0.30%**	**0.50%**	**0.40%**	**0.27%**

The Company has revised its fee structure and has cut down on management fee. The fees payable by the institutional investors are lower so as to attract large amount of capital. Trusteeship fee is fixed by SEBI hence it is left out of cost cutting measure.

Author finds that Fund houses are left with two alternatives to reduce the expenses and remain sustainable in the business. Fund houses generally decrease the fee/brokerages by –

Management fee – A viable alternative is reduction in management fee payable to the Fund Managers if the performance does not measure up to the expectations. Almost every Fund seeks to save money on management fee.

Distributor Brokerage – Another way to cut on costs and improve margin is to pay lower brokerage to distributors. This cost cutting strategy is also practiced widely.

Author finds on analysis that a lower brokerage can hurt a fund because distributors sell mutual funds primarily for brokerages and such a strategy can be very unpopular (While the management fee can be negotiated within the company's staff)

The Author finds that second reason for low market share of JM Financial is below-par performance of various funds operated by the Company. A comparison of performance of top performing funds was undertaken and is shown in Table-3.

Table 3: Top performing funds
(6 months performance in % return) till June '12

Rank	Scheme Name	NAV (Rs.)	Last 6 Months	Since Inception
1	HSBC Midcap Equity Fund - Growth	17.75	28.01	8.4
2	ICICI Prudential Banking and Financial	17.11	27.69	14.96
3	UTI Banking Sector Fund Growth	39.09	25.93	17.83
4	HSBC Progressive Themes Fund - Growth	10.37	24.94	0.58

5	Reliance Banking Fund Growth	93.61	24.79	27.87
6	Sahara Banking and Financial Services	27.34	24.72	30.45
7	Canara Robeco Emerging Equities	22.92	24.09	12.12
8	ICICI Prudential MidCap Fund - IP	12.29	23.77	3.38
9	Principal Emerging Bluechip Fund	26.97	23.72	31.46
10	ICICI Prudential MidCap Fund Growth	29.46	23.01	15.12
11	BNP Paribas Mid Cap Fund Growth	9.89	22.54	-0.17
12	JM Core 11 Fund - Growth	3.24	22.37	-22.95

As indicated in Table-3, even when JM core 11 fund has achieved 22.37% return in last 6 months of study, the fund has lost Net Asset Value (NAV) at the rate of (-)22.95% per year since inception. The NAV has been reduced to Rs. 3.24 from initial NAV of Rs. 10.

It may be noted that the above mentioned fund is among the worst performing fund by the Company. There are better performing funds like JM Arbitrage Advantage Fund have shown returns of the order of 9.45% in last 6 month. But still the performance is not at par with funds like HSBC, ICICI, etc.

The Author notes that with the advent of internet and other sources of ready information, the general awareness among investors increase and calls for more transparency. In effect, more and more investors get access to financial information in a click of the mouse. These investors demand best performing funds from his/her advisors.

A high performance fund can manage to pay extra commission in order to sell its products, and that gives it dual advantage. In contrast a low performance fund finds it hard to pay generous commission and it never becomes “the Hot” fund. Hence in an information age it is vital to achieve a superior performance to attract investors’ attention.

Findings

The low market share is primarily because of intensely competitive mutual fund market in the Country and comparatively below par performance of equity funds offered by JM Financial. The funds offered by the Company score low on visibility and recommendation because of significant reduction in commissions paid to brokers and distributors. Especially after the entry load was abolished by SEBI, small distributors do not have significant incentives to sell.

Recommendations

- Increase in Brokerages and Commissions – The Company should increase the brokerages to the industry level of 2% and make them more competitive as compared to other aggressive players in market. Doing so, will make it more competitive and help to increase market share.

- Cost reduction – To increase AUM and market share the company needs to reduce cost and expenses a little bit. The Author feels that the best way to go about is to charge lower fee (reduce by 5-10 bps) from institutional investors. Institutional investors invest a lot of money and help to garner market share.

- Access to semi urban areas – Again in semi urban and rural areas, there is lot of potential in Indian markets. JM financial needs to empanel new distributors in these areas and increase its penetration. Only 5% on Company's AUM comes from small cities so market penetration in these towns and cities should be done. (JM-Financial.DATA)

- Investor Awareness Programs – The Indian mutual fund industry has immense growth potential, and if aided well by technological advancements and increased awareness, MFs can be a major contributor to the overall Indian economy. However, it appears, the industry has not learnt from its past mistakes. The industry still seems to be operating on an asset gathering mandate, and not an asset managing one; the focus of the industry still seems to be driven by business agendas and not on building a community that is truly concerned about its investors (Economic Times, 2012). India still remains one the most unexplored markets in the world. Lately there have been attempts to increase awareness but more such efforts should be taken in order to tap unlimited opportunities. It is recommended that investor Awareness programs should be conducted more regularly say once in three months.

- Product Diversification – The Company should invest in other emerging markets such as Brazil, China etc. and come up with new products to increase its products portfolio to get a pie of their action.

- The Company should seriously look into its performance which has not been extraordinary in previous years. No matter other things, a fund's performance is of utmost importance and is foremost factor in consumer preference of the product such as mutual fund.

Summary and Concluding Remarks

Small mutual funds in general and JM Financial in particular can benefit by increasing the awareness, accessing semi urban areas and revisiting the brokerage patterns.

In order to promote the sagging mutual fund industry, Finance Ministry is contemplating to advise market regulator SEBI to consider re-introducing commission for brokers, known as entry load. Re-introduction of entry loads, which will boost income for funds and help in reviving stagnated mutual fund industry in India (Business-Line).

Investors have the right to get quality advice from their financial advisors and distributors (which is often the same thing). In essence the recommendation should not only be based on commission received but the quality of the fund and returns it is capable of generating.

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