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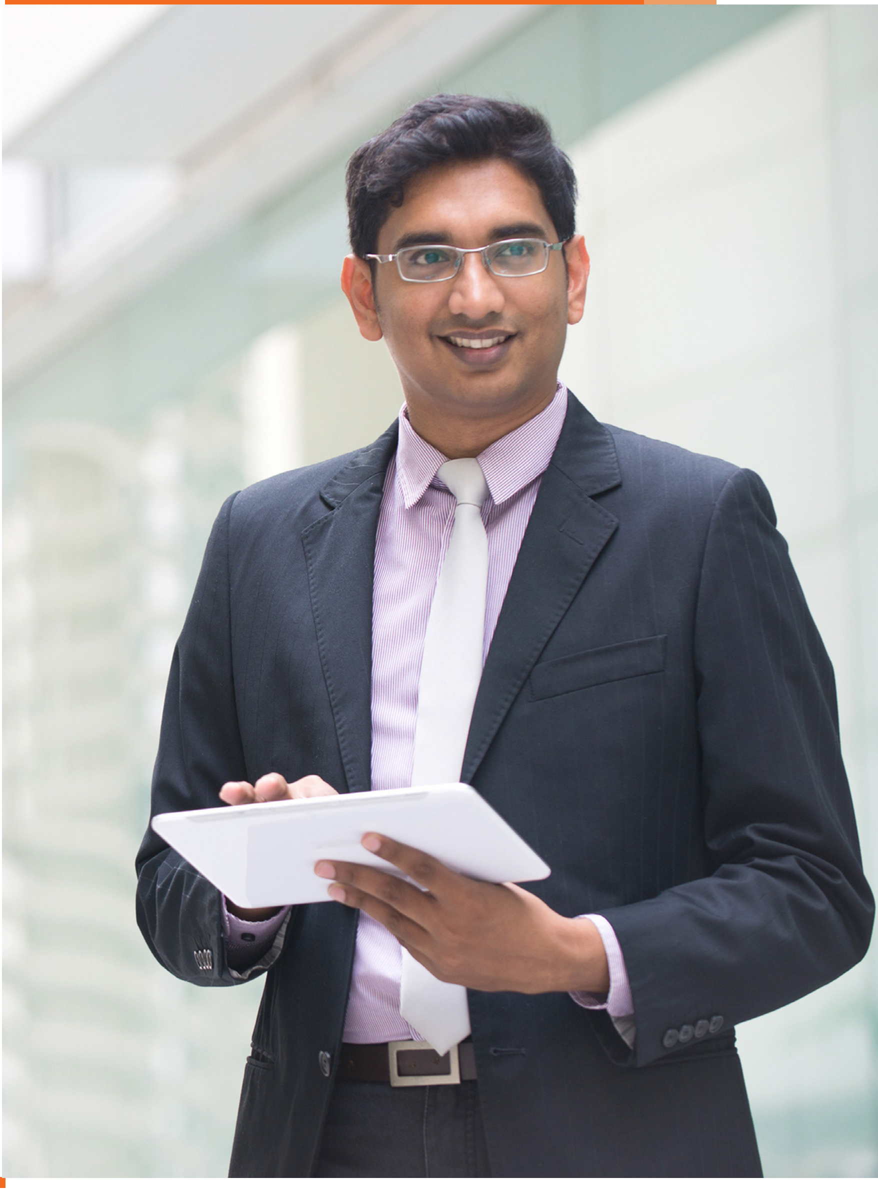
Categorisation of mutual fund schemes

What SEBI's circular means for investors and AMCs

November 2017



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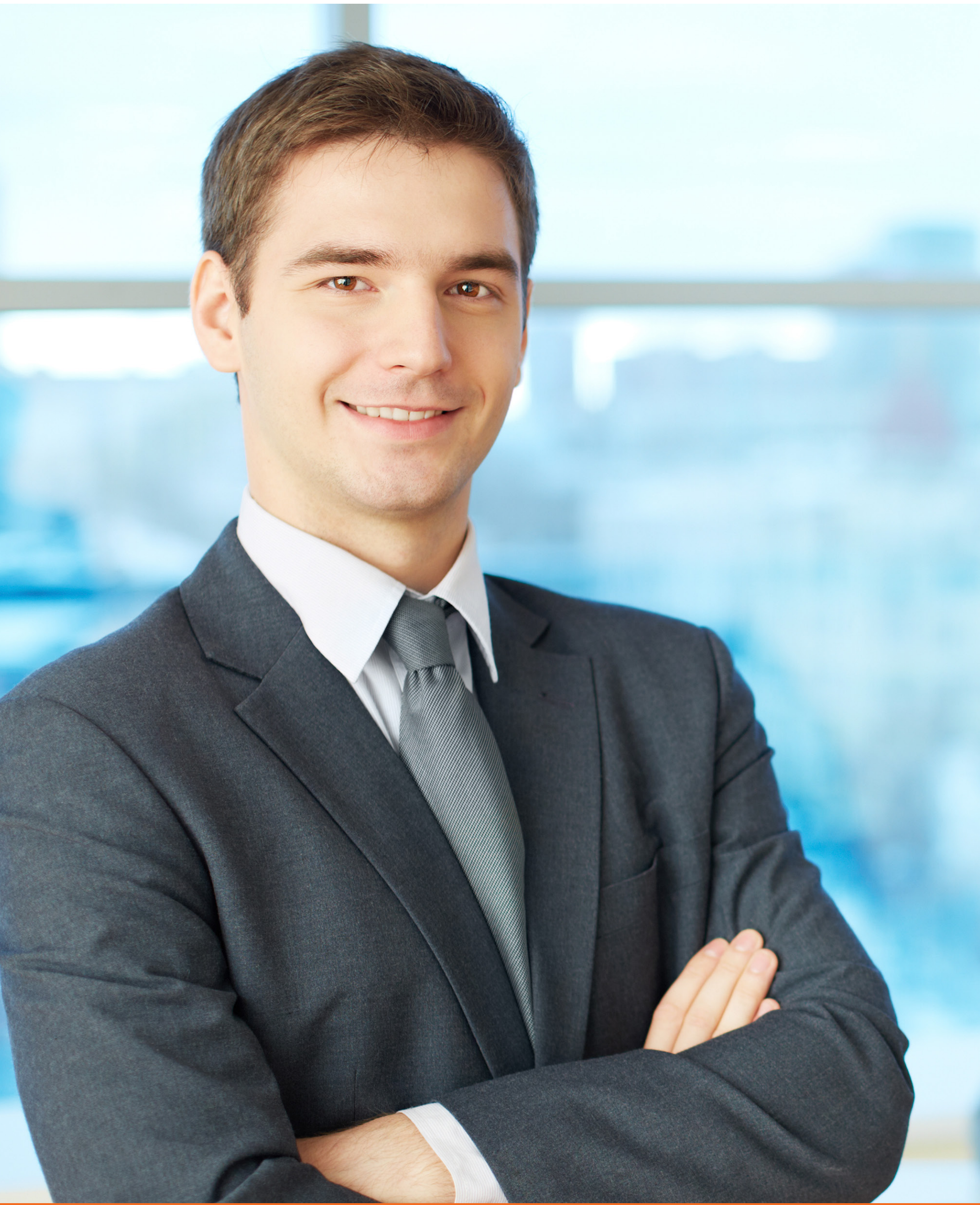
What does the SEBI guideline say?

On 6 October 2017, the Securities and Exchange Board of India (SEBI) issued a circular in order to rationalise and categorise open-ended mutual fund schemes in India.

SEBI's circular on mutual fund scheme categorisation and rationalisation aims at decluttering the existing industry by simplifying mutual fund investments for investors and enhancing comparability within the schemes offered.

We believe that the regulator has taken a positive step towards scheme rationalisation. This action will act as a catalyst for the growth of the mutual funds industry.



SEBI's objective

01 Create uniformity in the characteristics of similar types of schemes.

02 Enhance transparency and standardise disclosure requirements.

03 Group and name mutual fund schemes based on investors' underlying investment objectives.

04 Offer flexibility to investors on the nature of investments and risk exposure.

SEBI's proposition

01 Categorisation of large, mid and small cap categories of stocks

02 Grouping of mutual fund schemes into five broad categories: Equity, debt, hybrid, solution-oriented and others

03 Naming convention of schemes, especially debt schemes, as per the risk level of end investments

04 Categorisation of balanced funds into three types: Conservative hybrid fund, balanced hybrid fund and aggressive hybrid fund

What's in it for investors?

Ease in comparing mutual fund schemes offered by different asset management companies

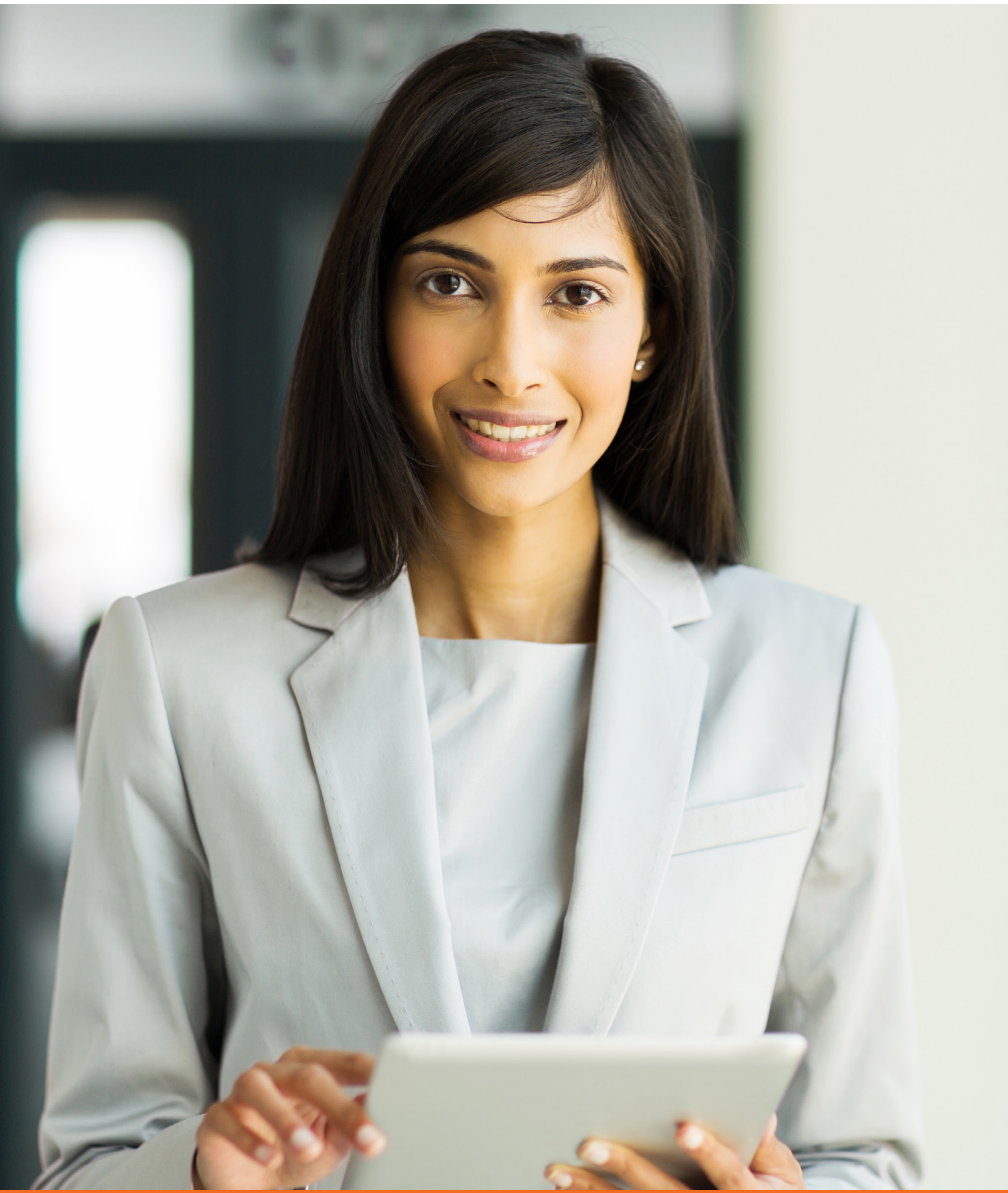
Enhanced transparency to ensure that investors align their financial goals and make right investment decisions

Merging of various schemes might bring uniformity in commission paid by asset management companies (AMCs)

Scheme merger will bring down the number of portfolios to be managed, thereby giving time to fund managers to focus their efforts on generating alpha

What investors need to focus on

- Investors might have to bear the burden of capital gains tax where they opt to exit from schemes in case of mergers.
- Fund managers may have to reshuffle scheme portfolios every six months, which will increase their costs and impact their returns.
- The nature of risk carried by debt schemes may still not be understood well by investors as simply changing the name might not highlight the quantum of risk element in these schemes.
- Hybrid schemes, under the current categorisation, have been defined. However, for an investor, the scheme differentiator will still remain a concern.



Impact on fund houses

Churn in portfolio: Every six months, fund managers may be required to reshuffle portfolios based on investment categorisation (large, mid and small) published by the Association of Mutual Funds in India (AMFI). This may lead to higher portfolio turnover and an increase in transaction costs, directly impacting fund returns.

Risk of front-running: Re-categorisation of certain stocks from large to mid, mid to small or vice versa on a half-yearly basis may result in the front-running of these stocks.

Increased cost due to scheme mergers: The merger of schemes will result in the renegotiation of distributor commissions and the management of trails, thereby increasing transaction costs.

Shrinking of the mid-cap universe: Post SEBI's regulation, there will be only 150 companies categorised under the mid-cap universe as compared to the current 400 stocks, as a result of which fund managers will have limited options to invest under the mid-cap category.

Full market capitalisation instead of free float for ranking: The new guideline categorises stocks based on full market cap instead of free float. This will create liquidity impact among stocks. Certain stocks which may rank high in case of free float might rank low under the full market cap method.

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