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ASSOCHAM

MUTUAL FUND INDUSTRY

Sustaining growth in emerging markets

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The Associated Chambers of Commerce and Industry of India

1, Community Centre, Zamrudpur, Kailash Colony, New Delhi-110 048

Tel: +91-11-46550555 (Hunting Line) • Fax: +91-11-46536481/82, 46536498

E-mail: assocham@nic.in • Website: www.assocham.org

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Introduction

The Indian mutual fund industry has gained immense experience and continues to reinvent itself gradually, exhibiting steady growth over the last decade. A compound annual growth rate of 28% has been recorded by assets under management over the period 2006-10. In today's volatile market environment, mutual funds are looked upon as a transparent and low cost investment vehicle, attracting a substantial amount of investor attention

The industry is undergoing rapid transformation, with multiple developments taking place on the regulatory front, all ostensibly with the primary objective of protecting the investor and streamlining trading practices to bring in more efficiency. The market participants are in a watchful mood, waiting to see how the industry adapts to these changes. Asset management companies are restructuring their business models in order to sustain the growth momentum of the industry, and provide for increased levels of operating efficiency and investor satisfaction. The industry continues to battle with the challenges of increasing investor awareness, low retail participation, high dependence on the corporate sector and increasing cost of operations. Mutual funds need to play an anchor role in directing the household savings into capital markets.

Assets under management as % of GDP are below 5% in India as compared to 70% in the US, 61% in France and 37% in Brazil. To increase penetration levels of mutual funds, the focus on inclusive growth has taken centre-stage, with all efforts by the regulator and fund houses being concerted in this direction.

It is therefore necessary to reach out to people in Tier II and Tier III cities, which is a daunting proposition considering costs of distribution and outreach and hence planned steps need to be taken to attain some of the long term objectives of financial inclusion. The rising incomes in Tier II and Tier III cities would indicate the latent potential in these cities. It is a matter of channelising their savings appropriately into mutual fund investments, for which investor education is a necessary first step.

This report seeks to discuss mutual funds as a mature asset class and stresses on the need to spread awareness of this product as a good investment option, especially in the smaller towns and cities. It emphasises the need to reinforce and sustain investor confidence in these times of uncertainty, through enhanced transparency and flexibility in the process of buying or selling these instruments. The report also touches upon the emerging markets which have been attracting global and domestic investors alike on the need to invest safely, keeping in mind the various risk factors.

The section on regulations, encapsulates the numerous regulatory changes which have been formulated recently to supplement the protection of investor rights impacting the industry as a whole.

Investor education is the first step towards investor protection

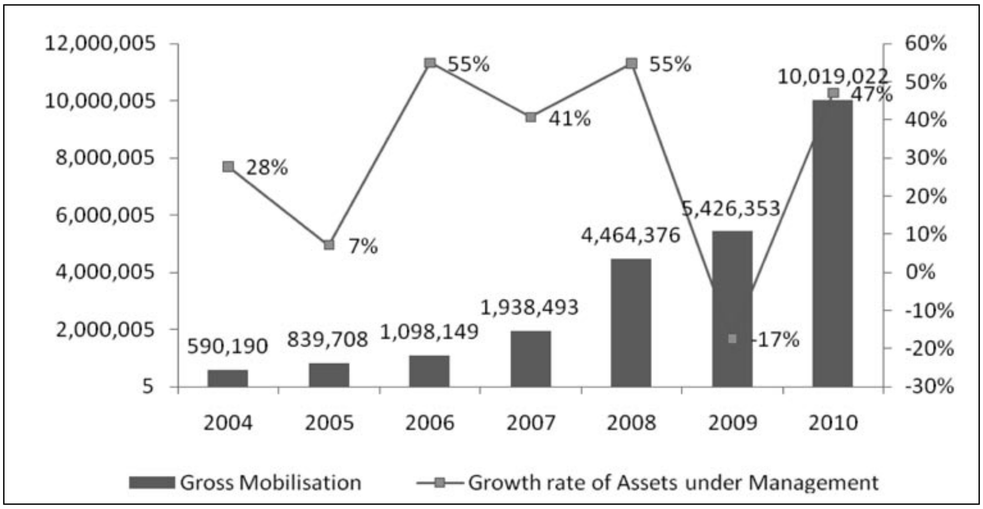
The financial services sector seems to be chanting the mantra of financial inclusion, with all types of financial intermediaries trying to focus on bringing a larger number of people under the net of financial services products. The benefits arising out of the high growth story of India deserves to percolate to the smaller towns and cities, where people have the investible surplus to channelise into appropriate financial instruments. The younger generation seems to be more comfortable with the concept of investment vehicles such as mutual funds and insurance directed towards wealth management. This is likely to result in financial service providers enhancing their revenue base.

India is backed by a relatively impressive savings and investment rate, which moderated around 32.5% and 34.9% in 2008-09. Net financial savings of the household sector have been estimated to touch 11.9% in 2009-10, higher than 10.2% in 2008-09. Inspite of this, the savings of the economy are not adequately channelised into financial instruments. The prime reason for this is attributed to lack of investor awareness, low levels of financial literacy and people in smaller towns and cities not aware of the combination of savings and attractive returns that investment in mutual funds can generate. This section of the population continues to follow the conservative approach of putting their savings in bank deposits, land or property and even gold. To mobilise new household savings, asset management companies need to reach out to the Tier II and Tier III cities.

The gross mobilisation of resources by all mutual funds during 2009-10 was

Rs.100,190 billion as compared to Rs.54,264 billion during the previous year indicating an increase of 84.7% over the previous year (Fig 1).

Fig 1
Gross Mobilisation of funds by MFs (in Rs Crore) and Growth of Assets under Management (%)



Source: SEBI

Some of the ways in which greater awareness about mutual funds is being brought includes organising investor meets, using multiple vernaculars, aided by the technology of mobile phones, use of advanced business models etc. To improve connectivity in remote areas, steps need to be taken by telecom operators to establish public telephones, common service centres etc. Extensive investor campaigns are being rolled out by fund houses to educate the investor about the various schemes and build an understanding of investment options over the short term as well as the long term.

These campaigns and programs should be designed to aid the investor in formulating his investment goal and planning to achieve it over a defined time horizon. Concepts of financial planning should be introduced and newer opportunities should be created to distribute mutual funds in the rural and semi-urban areas.

AMFI has reported that in the current financial year till July 2010, 24 AMCs have conducted 798 Investor Awareness Programs covering 136 cities and 29,430 participants.

Having said this, it is just not enough to educate investors and create awareness. In these times of uncertainty and high volatility, it is equally vital that advisors and agents are transparent in their dealings and impart all necessary and relevant details to the investor, to help him make an informed investment decision. For mutual funds to gain popularity, it is important for advisors to cultivate the faith of the investors on a continuous basis.

Lifting investor awareness will also provide a boost to multiple distribution channels, fuelling further growth of the industry. Tier II and Tier III cities have limited presence of asset management companies, and investors in these cities can leverage the online trading platforms to invest in mutual funds. Spreading investor awareness in these areas is a slow process which entails a lot of endurance. Creating awareness about gold exchange traded funds, where investors do not need to bother about keeping their gold safe or lose money on resale of physical gold, will help tap the existing potential from a class of investors who have the lure of the yellow metal.

Initially, the target group should include the middle and upper – middle class income group who are not familiar with or accustomed to the dynamics of the capital market. They in turn, could act as "opinion makers" for the lower income groups after gaining confidence in this asset class and ease of investments.

Transparent and flexible products, simplified documentation procedures and relatively low cost and size of initial investments, are some of the aspects which can make mutual funds an attractive proposition for the uninitiated. Over time, riding on strong macro-economic fundamentals, increasing levels of disposable income and a vibrant stock market, will continue to make the avenue of investment in mutual funds, attractive.

It is important to stress on the need to have a defined financial goal and establish a plan to achieve this goal through investments. One of the best incentives to channelise savings into mutual fund products is that it can be customised to cater to short-term as well as long term investments, depending on the type of fund chosen.

Since protection of investor rights is uppermost in the minds of all stakeholders in the mutual fund industry, investor education is seen as a huge step forward in this direction. Educating the customer will make the customer capable of making an informed investment decision and strategise his long-term investment plan. Building an understanding of the mutual fund product, and outlining the risk attached will help the customer to put his money in the right pockets. It will also help the investors to take the necessary precautions while dealing with market intermediaries, so that they are not waylaid in any manner.

This kind of a scenario will automatically lead to protection of the investor on a very broad level. Investors should therefore leverage the various programs and initiatives launched by AMFI and the fund houses on investor protection and awareness campaigns.

SEBI acclaims investors to be the backbone of the capital market, and plans to push the agenda of investor protection further to the forefront. Apart from awareness campaigns, workshops to familiarise the investors with the working of the capital markets, advertisements, standardised reading materials, messages through radio, television, website etc have been rolled out in the interest of the investors.

The need to sustain Retail investor confidence in mutual funds

Though the appetite of retail investors in India for participating in the country's growth story remains to be satiated in a big way on the part of investors, over a medium to long term horizon, the investors are well aware of the equity markets showing signs of having good potential for capital appreciation.

Participation in the mutual fund industry remains skewed towards the corporate investors, involving low participation from the retail sector. As of March 2010, the corporate sector contributes around 51% of the total assets under management, while the retail segment contributes only around 27% of the total assets under management, which is a slight increase from 21% reported in the previous year.

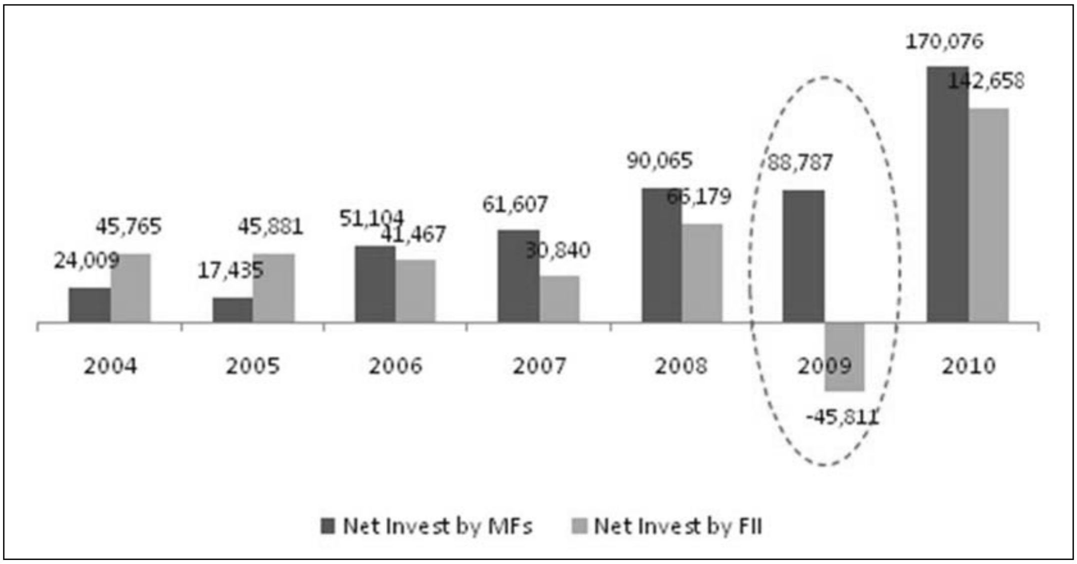
Investor confidence in the securities market took a beating during the downturn, and since the course of the mutual funds shadows that of the capital market, investors also lost faith in mutual funds, leading to a lot of redemption pressures for fund houses. Investors should be encouraged to migrate to mutual funds from other traditional modes of investment and should be prepared adequately to take measured risks. One of the reasons why mutual funds have failed to cultivate the confidence the investor is that most often, the risk attached to the product is "under wraps". Thus, the long term benefits of remaining invested in these funds over a long term horizon are lost on the investor. The result is that, a product designed for a small investor fails to foster a market for itself.

Implementing disclosure practices is likely to lead to increased transparency, which may result in increased confidence of the investor.

Capital markets in India, perceived as part of one of the fastest growing economies, have caught the attention of global investors. Foreign investments have poured into the country, with around $20 billion ploughed into the capital markets in the period January 2010 to November 2010. In March 2010, the number of SEBI registered FIIs went up to 1,713 from 1,635 a year ago. Their net purchase in equities was $23 billion in 2009-10 against net sales of $10 billion in the previous year. The total net inflow of FII was Rs.1,427 billion ($ 31 billion) as against an outflow of FII of Rs.458 billion ($10 billion) in 2008-09.

Fig 2

Net Investment by Mutual Funds and FIIs (in Rs Crore)



Source: SEBI

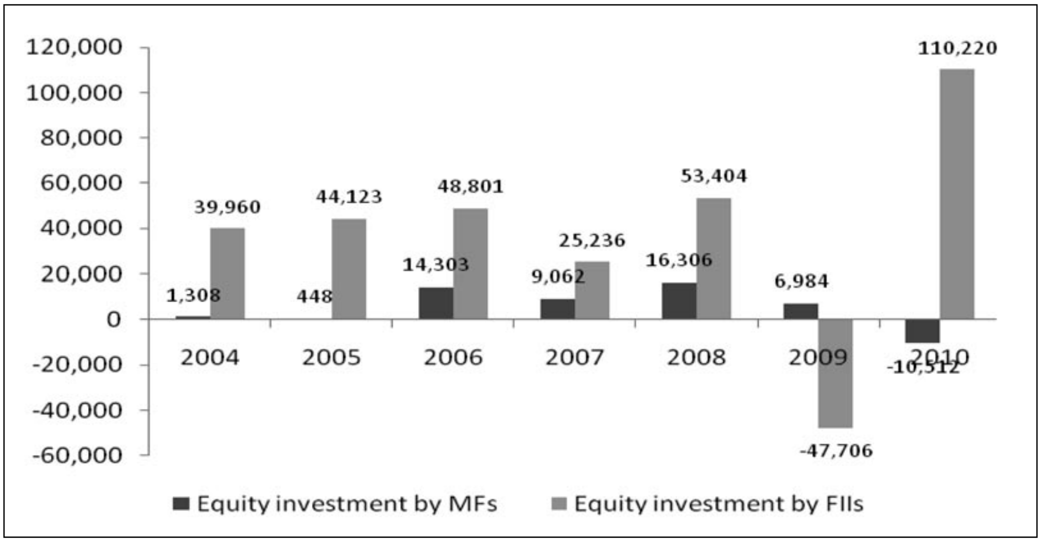
The decline in investments by both FIIs and mutual funds during 2008-09 is evident in Fig 2 above, emanating primarily from a massive decline in equity investments.

Investments of mutual funds in equity was Rs 163 billion in 2007-08, and witnessed a fall of 57% in 2008-09 to stand at Rs 70 billion. FII investment in equity also exhibited a similar trend, with outflows of Rs 477 billion of equity investments from the market. These statistics clearly reflect the plummeting confidence of the investor in the equity markets.

The year 2009-10 saw a bounce back to some extent of the faith of the global investor, as FIIs resumed investing in the Indian market with equity inflows witnessing a surge, recording Rs 1,102 billion. However, mutual fund investments failed to pick up the positive notes with 2009-10 seeing an outflow of Rs 105 billion from the equities market.

Fig 3 below illustrates the flow of equity investments by Mutual funds clearly indicating that the low levels of investor confidence need to be boosted in this segment.

Fig 3
Flow of Equity Funds by MFs and FIIs (in Rs Crore)



Source: SEBI

This said, although equity investments by mutual funds declined, the investments in debt proved attractive during the downturn, attracting a large number of takers. This asset class can also therefore seek to increase retail participation at the aggregate level.

SEBI, realising the important role investor confidence plays in driving market sentiments positively, has taken various regulatory stances to assert the faith of the investor. Some of these are, introducing the concept of an anchor investor, disclosure in rights issue offer documents, listing of unlisted firms, reduction in fees, and issue of shares with superior voting rights.

Transparency in the load regime and payment of commission has been introduced to incentivise the customer to stay invested over a longer term.

In August 2009, restriction on entry loads was announced for mutual funds, where commission was to be paid directly by the investor to the distributor, depending on the service rendered. It is expected that this would segregate the streams of payment for the two roles of distributor, as a point of sale for the asset management company and an advisor to the investor. Many mutual fund investors leverage the services of the distributor acting as a financial advisor who is expected to assist investors in choosing schemes that suit their respective risk-return appetite besides assisting him in the application procedure.

To protect the mutual fund industry from a frequent churn and safeguard the interest of investors, a step to restrict entry loads was undertaken. This is likely to result in empowering the investor to decide the commission to be paid to the distributor, ensuring transparency in commissions paid, based on the quality of service received.

Curtailing malpractices in trading, will nurture investor confidence

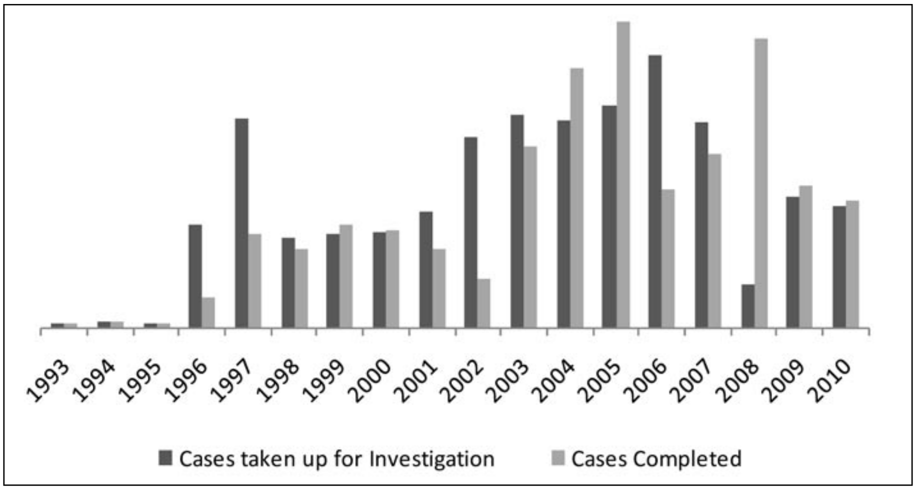
The mutual funds, as per the regulations, are set up as trusts and thereby have a fiduciary duty towards their investors. The responsibility of these trustees involves ensuring that the trading of mutual funds are aligned to the regulations and interests of investors are duly protected.

Regulations have been devised to prevent fraudulent activities and digressions from deceptive and manipulative practices by insiders associated with personal securities transactions and any Mutual Fund, which indulges in unfair trade practices in securities, shall be dealt with in the manner provided under the Securities and Exchange Board of India (Procedure for Holding Enquiry by Enquiry

Officer and Imposing Penalty) Regulations, 2002.

Characteristically, the nature of unfair trade practices is predominantly that of market manipulation, and price rigging. Some of the other irregularities may be that of insider trading, takeover violations, and violation of norms in capital issues, non-disclosures under SEBI regulations and illegal carry forwards.

Fig 4
Investigation Cases by SEBI



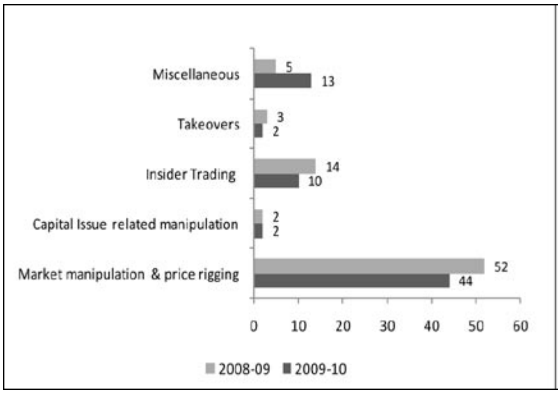
Source: SEBI

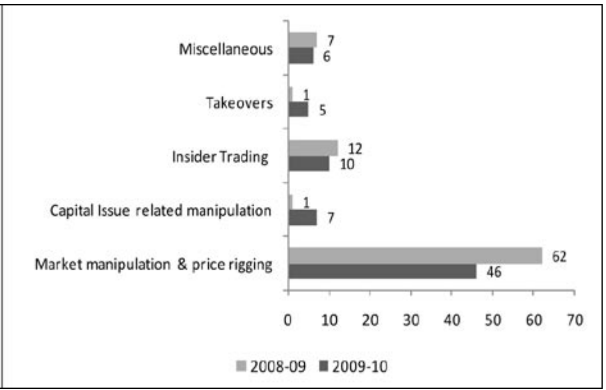
Fig 4 shows the number of cases investigated by SEBI over a period of almost the last two decades, indicating that with the growth of the mutual fund industry several gaps and loopholes in trading practices have been revealed, instigating unfair trading practices.

Although technology acts as a huge facilitator to efficient trading mechanisms, it also adds to the burden of fraudulent activities as newer methods are being used to violate laws and regulations. During the year 2009-10, about 62% of the cases taken up for investigation pertain to market manipulation and price rigging, as against about 68% of such cases in the previous year. It has been observed that the reason behind market manipulation is on most occasions a large network of front entities that trade with unfair means.

Fig 5

Nature of Investigations taken Up **Nature of Investigations Completed**





Source: SEBI

Fig 5 illustrates the most pertinent cases of investigation which occurred during 2008-10, suggesting that miscellaneous cases included investigations pertaining to GDR conversions, trading pattern in the market after public issue, illegal carry forwards, non-disclosures under SEBI Regulations, Fit and Proper Regulations, etc.

To protect investors from these unfair means, the need to have a sound Customer Due Diligence (CDD) regime, a comprehensive "In-Person" verification process and ongoing monitoring of transactions by the registered intermediaries is well recognised.

To ensure that trading practices are in order and investor's rights are duly protected, it has been established in a SEBI directive that responsibility for all documentation involving the investor or customer will rest on the shoulders of the asset management company. The trustees have been entrusted to take action in cases where they find the documentation details to be incomplete or unavailable. Mutual funds also need to ensure compliance with the investor's instructions to change his distributor or trade directly, without obtaining a NoC from the existing distributor.

Regulations facilitate investor protection

A. Evolving regulations impacting governance

Securities Exchange Board of India ('SEBI') as a Mutual Fund ('MF') regulator has primarily focused itself on protecting investors' interest. This has been clearly evident in the reforms and from the amendments in the MF regulations in recent times. In all its circulars, SEBI has time and again reiterated that the changes sought to be made are to enhance transparency, uniformity and accountability in the industry. Some of the key amendments are briefly discussed below:

Amendments to the expense structure charged by the Fund of Fund Schemes

In an effort to further regulate management expenses, the Regulator has amended the expense structure charged by Fund of Fund ('FoF') Schemes. SEBI had restructured the total expense, including management fees, charged from investors in a FoF scheme to 0.75 percent of either the daily or weekly average net assets[1]. Alternatively, the fund houses should cap management expenses at 0.75 percent and fix their own fee for administrative expenses, provided the total charge does not exceed 2.5 percent of the daily or weekly average net assets. However, the fund houses offering FoF schemes need to clearly spell out the expense structure that they will be adopting and change the expense structure after giving the unit holders an option to exit.

In the past, Asset Management Companies ('AMCs') had been entering into revenue sharing arrangements with offshore funds in respect of investments made on behalf of FoF schemes. SEBI has issued directions prohibiting AMCs from entering into any revenue sharing arrangement with the underlying funds in any manner[2].

NISM	***The new certification exam for distributors will now be conducted by the NISM and not AMFI***

[1] *Vide Circular No. LAD-NRO/GN/2010-11/13/13945 dated 29 July 2010*
[2] *Vide Circular No. SEBI/IMD/CIR No 18 / 198647 /2010 dated 15 March 2010*

Regulation of distributors

Distributors of MF units were required to obtain certification from the Association of Mutual Funds in India ('AMFI') by passing a certification examination and to obtain registration with AMFI. In order to improve their efficiency, the Regulator felt the need to overhaul the certification process of MF advisors. SEBI decided that the certification examination for distributors of MF would be conducted by the National Institute of Securities Markets ('NISM')[3].

Entry Load

SEBI had prohibited charging of initial issue expenses, which were permitted for closed-ended schemes, and mandated that such MF schemes shall recover sales and distribution expenses through entry load only. These steps were aimed at creating more transparency in fees paid by investors and helping investors in making informed investment decisions.

Subsequently, with effect from 1 August 2009[4], SEBI banned the entry load that was deducted from the invested amount, and instead allowed customers the right to negotiate and decide commissions directly with distributors based on the investor's assessment of various factors including quality of services rendered. The objective was to bring about more transparency in commissions.

Trading through stock exchange platforms

To broad base the distribution network and to facilitate ease in transaction, units of schemes are now permitted to be transacted through registered stock brokers of recognised stock exchanges[5]. Subsequently, the Bombay Stock Exchange and National Stock Exchange have launched trading platforms enabling investors to invest by availing the services of stock brokers. The intention behind this move appears to make investments in MF more accessible to investors.

Unrestricted transfer of mutual fund units

In order to make investing a smooth process for investors, SEBI has instructed mutual fund houses to clarify by way of an addendum that units of mutual fund

[3] *Vide Circular No. Cir / IMD / DF / 5 / 2010 dated 24 June 2010*
[4] *Vide Circular No. SEBI/IMD/CIR No. 4/ 168230/09 dated 30 June 2010*
[5] *Vide Circular No. SEBI /IMD / CIR No.11 / 183204 / 2009 dated 13 November 2009*

held in a demat form will be freely transferable from the date of the issue of the addendum[6].

Unit Premium Reserve	MFs can not use unit premium reserve to distribute dividends; only realised gains to be used

Dividend only from Realised Gains

SEBI has barred fund houses from tapping the unit premium reserve to distribute dividends2. Instead, it has directed MFs to pay dividends only from realised gains. MFs and distributors have used dividend declaration as a promotion tool to attract investors. The revised norm will protect investors' interest and curb mis-selling.

Documentation

SEBI had observed that AMCs do not maintain all documents of investors, thereby restricting the rights of the investors to approach the AMCs directly and investors are forced to depend on the distributors for executing transactions. With this in mind, SEBI had made it mandatory for all AMCs to maintain a copy of full investor documentation including Know Your Customer i.e. KYC details. Such documentation was earlier maintained by the respective MF distributors who have now been asked to give a copy of the same to the fund houses. In this regard, SEBI directed all MFs to ensure complete documentation as per the prescribed KYC.

In order to ensure that investors have unrestricted access to AMCs and to enable AMCs to provide prompt investor service including execution of investors' financial or non-financial transactions, the Regulator has directed[7] all MFs/ AMCs to:

- open new folios/ accounts only after ensuring that all investor related documents including account opening documents, PAN, KYC, PoA (if applicable), specimen signature are available with AMCs/ Registrar and Transfer Agents and not just with the distributor.
- update investor related documents including account opening documents, PAN, KYC, PoA (if applicable), specimen signature for existing investors by 15 November 2010.

[6] *Vide Circular No. CIR/IMD/DF/10/2010 dated 18 August 2010*

[7] *Vide Circular No. Cir / IMD / DF / 9 / 2010 dated 12 August 2010*

Disclosure of Investor Complaints

MFs should disclose on their websites, on the AMFI website and in their annual reports, details of investor complaints received by them from all sources. SEBI has issued a Circular that requires MFs to include details of investor complaints in their Annual Report as part of the Report of the Trustees, beginning with the annual report for the year 2009-10[8]. The disclosure would show how effectively a fund house is servicing its investors and would also helps investors in their decision making.

15 Days	*The subscription period for New Fund Offer is now lowered*

Reduction of New Fund Offer period

The earlier new fund offer (NFO) subscription period of 30 days (open- ended schemes) and 45 days (closed – ended schemes) is now reduced to 15 days (except Equity linked Saving Schemes)[2]. Mutual funds should allot units/ refund money and dispatch statements of accounts within five business days from the closure of the NFO.

5 Days	*Time within which funds have to allot units / refund money & dispatch statement of account from the closure of the NFO*

ASBA facility extended to MF investors

SEBI has instructed mutual fund houses to mandatorily provide Applications Supported by Blocked Amount ('ASBA') facility to investors investing in NFOs launched on or after October 1, 2010[9]. The move would help investors save interest cost on borrowing and help get rid of the hassles associated with refunds.

Exposure to Derivatives

With effect from 1 October 2010, SEBI has banned funds from writing options or purchase instruments with embedded written options[10]. Also, MFs should

[8] *Vide Circular No. Cir / IMD / DF / 2 / 2010 dated 13 May 2010*
[9] *Vide Circular No. Cir / IMD / DF / 6 / 2010 dated 28 July 2010*
[10] *Vide Circular No. Cir/ IMD/ DF/ 11/ 2010 dated 18 August 2010*

have cumulative gross exposure through equity; debt and derivative positions of not more than 100 per cent of the scheme's asset size. SEBI also instructed funds to restrict the options exposure to 20 per cent of scheme's net assets. Furthermore, the regulator has also specified the format for MFs to disclose their derivative holding in their half yearly portfolio disclosure reports. The new regulation has come about with the intention of preventing unlimited downside risk a writer faces when an Option is assigned to him. The move, therefore, has resulted in alteration in the derivative exposure of MF products. The primary aim of these changes is to protect investors from the volatile derivative market.

Emerging global market opportunities – Attracting global investor attention to mutual funds

All the action seems to be concentrated in the region of the emerging markets as a surge in demand makes these economies attractive with a vast potential for growth. Investors are moving out of saturated markets like US, UK and Europe, characterised by their increasing levels of debt and looking towards emerging markets such as India, China, Brazil, Turkey to give a new direction to growth. World Economic Outlook projects that growth of output in emerging nations will be 7.1% in 2010 and 6.4% in 2011.

A report from Euromonitor which is aligned to the world economic outlook projections, says that by 2020 there will be a major shift in the global balance of economic power compared to 2010. Emerging economies will rise in importance and China will overtake US to lead the list of the world's top ten largest economies by GDP measured in Purchasing power parity (PPP) terms. Consumer markets in emerging economies offer tremendous opportunities but their rapid growth also poses a challenge to the global environment.

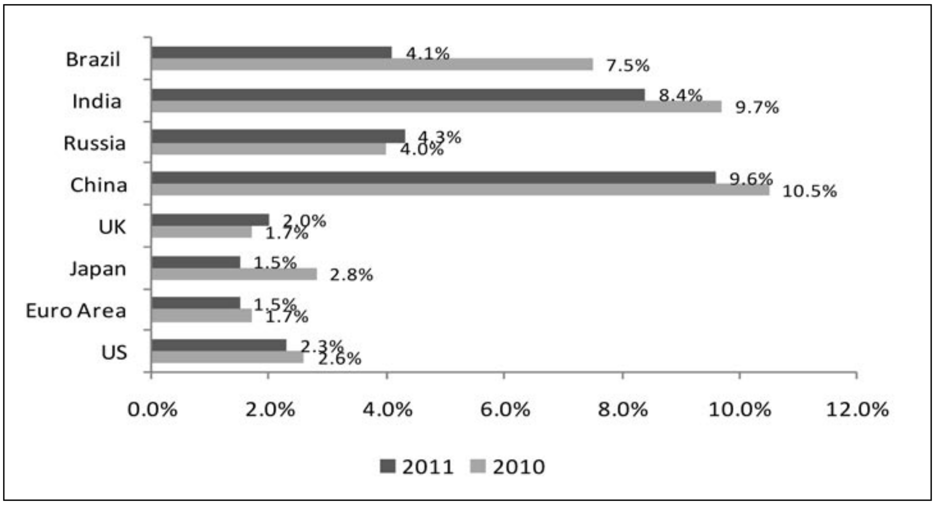
Emerging economies are catching up with the advanced world, and signs of change in the global balance of power are already visible. China's share in world total GDP in PPP terms has increased from 7.1% in 2000 to 13.3% in 2010. Euromonitor also suggests that by 2020, it will reach 20.7%. China will overtake US to become the world's largest economy as early as 2017.

Currently, India is the fourth largest economy in 2010. By 2012, it will have overtaken Japan to become the world's third largest economy, with GDP accounting for 5.8% of the world total in PPP terms. In the long term, India could grow even faster than China due to its younger and faster growing population.

Emerging markets represent 37% of the world's gross domestic product, and Goldman Sachs is estimating that they will represent 49% by 2020, hence signifying steady growth in years to come. The steady stream of FII inflows are evidence to the high growth story of India, offering better returns as compared to advanced economies.

Fig 6

Real GDP growth (%) Projections of emerging economies Vs advanced economies



Source: World Economic Outlook

In Fig 6 the growth rate of emerging nations is mapped against that of advanced economies like US, UK, and Japan, and reflects clearly the high expectations from the emerging markets of India, China and Brazil.

With a huge population and steadily rising household incomes, the consumer goods and service markets in emerging economies will provide enormous opportunities for businesses. In 2010, the total population of BRIC countries stood at 2,856 million people, compared to 737 million people in the G7.

Jumping onto the growth bandwagon, a variety of financial instruments like mutual funds, exchange traded funds, hedge funds and derivatives have mushroomed to tap the investor needs and create a larger base of customers. Although investing in individual stocks is an alternative, it is a more lucrative option to invest in mutual funds of emerging nations, especially BRIC. It diversifies the risk and ensures returns not limited to the growth of any one company.

With the global commodity markets buzzing with activity, the offering of commodity focused mutual funds is also seen as a good alternative to diversify investment portfolios and reduce risk levels.

With the emerging markets painting a high growth story, there is also a note of caution, as high levels of capital inflows is leading to higher valuation of markets in Asia. Measures need to be taken to create a safeguard against these huge waves of capital flows. Monetary measures need to be put in place to curtail high inflationary conditions and credit growth. A robust macro-economic framework needs to be outlined and established to absorb the inherent shocks.

Advanced financial sector reforms are required to add fuel to the growth triggered by huge consumption and investment demand. Improving access to credit and channelising household savings into lucrative investment avenues are some of the focus areas of these emerging markets. Apart from boosting per capita income, the challenge for emerging economies is to improve social security and environmental protection, in order to achieve a living standard comparable to that of advanced economies.

The advent of technology and the adoption of new technological standards in the emerging markets have been proclaimed as a catalyst for growth and progress for these vibrant economies. Interest rate differentials have also brought in an incentive to encourage investors to channelise their investments into these high growth economies.

Turning away from US stocks, a buoyant equity market has encouraged investors to shift their attention to emerging market investments. Emerging markets as of

2010, contributes around 13.1% to the Morgan Stanley Capital International (MSCI) index, which in 2002 was an insignificant 3.8%.

As per MSCI, components of the MSCI Emerging Markets Index have indicated a major shift over time. The allocations to BRIC countries have grown from around 25.6% of the total index in 2000 to around 49.1% as of July 2010.

Emerging market funds catapult investor attention

The year 2009 witnessed an inflow of $80 billion in emerging market funds, while simultaneously dealing with a withdrawal of $60 billion from developed economies like US, Europe and Japan. In 2010, investment into emerging market funds has aggregated $40 billion. An analysis by Goldman Sachs states that it is likely that the market value of emerging markets may increase to $80 trillion over the next 20 years from $14 trillion in 2010. Market researcher EPFR Global, says that the $68.5 billion invested in emerging market funds until October 2010 is quite likely to exceed the record level of $83.2 billion of 2009.

Bloomberg reports, that the Morgan Stanley Capital International (MSCI) World index generated returns on average 3.5% a year over the past five years till the end of March 2010, while the MSCI Emerging Market index generated returns of 15.7% a year.

Although most of the attention is centered towards the BRIC nations, there are the other emerging economies which also deserve attention like South Africa, Egypt, Turkey, Mexico, South Korea and Poland. These economies also boast of a high growth agenda with an investor – friendly environment.

Potent Risks attached to investing in Emerging Economies

Although emerging countries boast of treading a high growth path, there is an attached baggage of risks which comes along with this package. These economies are vulnerable to business cycles, currency upheavals, uncertainty in social environment, and protectionism prone to cyclical growth patterns.

Emerging markets being flooded by funds, is actually worrisome for their policymakers, who anticipate the risk of appreciating currencies having an adverse impact on domestic exports, which could result in a slowdown of economic growth. Moreover, creation of any asset bubbles in the securities and real estate markets, will lead to more complications in formulating fiscal and monetary policy.

Each emerging market, which is in a developing state has its own set of specific challenges; for instance while India is continually dealing with its characteristic volatile equity markets, Brazil is bogged down by an unsteady political situation, with a continued threat of inflation in China.

Some of the more pertinent challenges in the emerging economies

Lack of liquidity in these developing markets is quite often a burning concern for these economies. There is clear anecdotal evidence that in an illiquid market, a deluge of stock sales can send asset prices tumbling down. Since these economies are prone to over-investment, a situation in which prices crash can be a distinct possibility. Such instances prove quite harmful to the investor and succeed in further dampening investor confidence in the long run.

Another issue is that very few shares based in these developing countries are listed in US or are traded as American depositary receipts (ADRs). This creates a problem in buying dollar stocks, especially those aligned to the Securities & Exchange Commission reporting guidelines. An alternative solution to this challenge is the option of investing in emerging-market mutual funds or exchange-traded funds (ETFs), some of which target specific regions or countries.

Other key issues which may add to the risk of investing in emerging economies is the interplay of political influences which may affect certain key financial decisions. A well governed prudential framework is required to guide the financial markets towards best investment practices.

It is also speculated that an excessive spill-over of dollars into emerging markets may create a weakening of the US dollar and appreciate the domestic currency. Also, low cost of borrowing and active stock markets paves the way for creating asset bubbles, thereby increasing the vulnerability of these emerging nations.

A longer-term risk would be the lack of 'trickle down' effect in emerging economies.

As rapidly developing economies such as China and India grow, it is important that an increasing proportion of the population benefit from this growth. If wealth in these countries is not distributed quickly and equitably enough, there is a risk of social unrest. Although this remains a longer term concern for several emerging economies efforts are being made to address this concern. The Chinese government in particular, is aware of this issue and is trying to tackle it with, for example, increased government spending in rural areas. In India also, efforts towards financial inclusion are being revved up.

According to IMF "Some of the larger, fast-growing emerging economies, faced with rising inflation or asset price pressures, have appropriately tightened monetary conditions. Monetary policy actions must remain responsive in both directions. In particular, should downside risks to global growth materialize, there may need to be a swift policy reversal."

The global surplus savings should be channelised into the emerging economies to balance the demand in the world economy. Risks arising in these economies need to be curtailed with policies for monetary tightening and marginal exchange rate appreciation. Further, the fiscal policies should be formulated to address exchange rate concerns and moderate the pressure on interest rates. It is imperative to have adequate regulatory intervention and establish capital control measures to guard against excessive capital inflows.

Conclusion:

Emerging markets like India promise to increasingly embrace growth as they gain the confidence of the investor, as against the dip in investor's confidence in advanced countries like US, UK and Japan. Against this backdrop, mutual funds have emerged as a suitable investment option with their characteristic transparency, flexibility and low cost of investment.

Through this report, we have tried to trace some of the key aspects which affect the investor's decision to choose mutual funds as an investment option. The report stresses on the need to understand the concept of financial planning, setting financial goals and understanding mutual fund as a product to draw the desired returns. On the same note, there are also certain precautions and risk factors which investors need to be aware of to avoid getting caught in the loopholes of unfair trading practices.

The section devoted to discuss the regulations pertaining to protection of investors, touches upon the regulatory intervention which is required to keep the investor keyed in to their investments in mutual funds.

Lastly, attention has been drawn to the burgeoning growth of emerging economies, where investors are looking to earn better returns leveraging the interest rate differentials and the vibrant capital markets. However, a note of caution is sounded enumerating some of the risks which may have a long term impact on the investor and the economy as a whole. Thus, the need to have regulatory control to preserve these economies and make them more resilient needs to be duly re-emphasised.

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CONTACTS

Jairaj Purandare
Executive Director
Leader – Financial Services
Telephone: +91 22 6669 1888
E-mail: jairaj.purandare@in.pwc.com

Harsh Bisht
Executive Director
Leader – Banking & Capital Markets
Telephone: +91 22 6669 1282
E-mail: harsh.bisht@in.pwc.com

Gautam Mehra
Executive Director
Leader – Asset Management
Telephone: +91 22 6689 1155
E-mail: gautam.mehra@in.pwc.com

Robin Roy
Associate Director-Financial Services
Telephone: +91 22 6669 1360
E-mail: robin.roy@in.pwc.com

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