

## UNIT – II

### **New issue market / Primary Market**

A primary market is a place where companies bring a new issue of shares for being subscribed by the general public for raising funds to fulfil their long-term capital requirement like expanding the existing business or purchasing new entity. It plays a catalytic role in the mobilisation of savings in the economy.

Various types of an issue made by the corporation are a Public issue, Offer for Sale, Right Issue, Bonus Issue, Issue of IDR, etc.

The company who brings the IPO is known as the issuer, and the process is regarded as a public issue. The process includes many merchant bankers (investment banks) and underwriters through which the shares, debentures, and bonds can directly be sold to the investors. These investment banks and underwriters need to be registered with SEBI (Securities Exchange Board of India).

The public issue is of two types, they are:

- **Initial Public Offer (IPO):** Public issue made by an unlisted company for the very first time, which after making issue lists its shares on the securities exchange is known as the Initial Public Offer.
- **Further Public Offer (FPO):** Public issue made by a listed company, for one more time is known as a follow-on offer.

### **Features of the Primary Market**

#### **(1) It is related with New Issues:**

The first important feature of the primary market is that it is related with the new issues. Whenever a company issues new shares or debentures, it is known as Initial Public Offer (IPO).

#### **(2) It has No Particular Place:**

Primary market is not the name of any particular place but the activity of bringing in new issues is called the primary market.

#### **(3) It has Various Methods of Floating Capital:**

Following are the methods of raising capital in the primary market:

##### **(i) Public Issue:**

Under this method, the company issues a prospectus and invites the general public to purchase shares or debentures.

##### **(ii) Offer for Sale:**

Under this method, firstly the new securities are offered to an intermediary (generally firms of stock brokers) at a fixed price. They further resell the same to the general public. The advantage of doing this is that the issuing company feels free from the tedious work of making a public issue.

##### **(iii) Private Placement:**

Under this method, the company sells securities to the institutional investors or brokers instead of selling them to the general public. They, in turn, sell these securities to the selected clients at a higher price. This method is preferred as it is a cheaper method of raising funds as compared to a public issue.

##### **(iv) Right Issue:**

This method is used by those companies who have already issued their shares. When an existing company issues new shares, first of all it invites its existing shareholders. This issue is called the right issue. In this case, the shareholder has the right either to accept the offer for himself or assign a part or all of his right in favour of another person.

##### **(v) Electronic Initial Public Issue (e-IPOs):**

Under this method, companies issue their securities through the electronic medium (i.e. internet). The company issuing securities through this medium enters into a contract with a Stock Exchange.

SEBI registered broker have to be appointed for the objective of accepting applications. This broker regularly sends information about it to the company.

The company issuing security also appoints a Registrar, who helps in making the issue a success by establishing contact with the stock exchange. (Whatever method, out of the above five is adopted, it is the activity of the primary market.)

**(4) It Comes before Secondary Market:**

The transactions are first made in the primary market. The turn of the secondary market comes later.

**Primary Market Vs Secondary Market**

Basis for Comparison	Primary Market	Secondary Market
Meaning	The market place for new shares is called primary market.	The place where formerly issued securities are traded is known as Secondary Market.
Another name	New Issue Market (NIM)	After Market
Type of Purchasing	Direct	Indirect
Financing	It supplies funds to budding enterprises and also to existing companies for expansion and diversification.	It does not provide funding to companies.
How many times a security can be sold?	Only once	Multiple times
Buying and Selling between	Company and Investors	Investors
Who will gain the amount on the sale of shares?	Company	Investors
Intermediary	Underwriters	Brokers
Price	Fixed price	Fluctuates, depends on the demand and supply force
Organizational difference	Not rooted to any specific spot or geographical location.	It has physical existence.

**Role of Primary new issue market:**

**Capital Generation**

Primary markets enable firms to raise capital through the sale of financial assets. Businesses are able to access potential investors that are outside its immediate influence. Businesses have to meet stringent market standards to issue securities at the primary market. The added scrutiny makes the issue more attractive to potential investors, and the company is able to raise the capital with lower costs. The company can also continue to raise more capital for future investments through multiple issues because it is not restricted to a single set of investors.

**Liquidity**

Primary markets also help in making the financial assets more liquid. Investors in privately held companies are tied to the fortunes of the company. The primary market investors, on the other hand, are able to easily trade their investments in the secondary market. This liquidity makes investors less wary and enables companies to raise more capital easily. Indirectly, this translates to more investment in businesses and better job creation.

**Diversification**

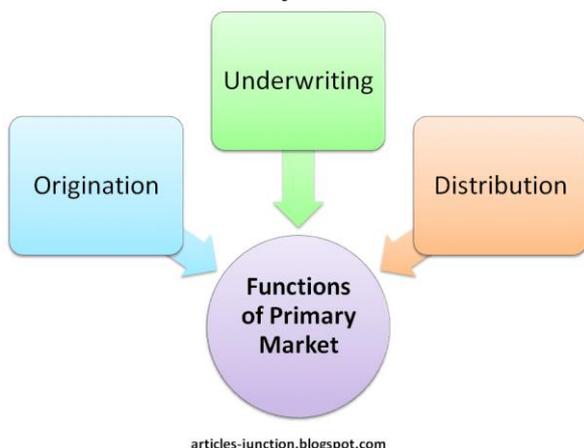
Risk reduction through diversification is another important part of the role that primary markets play in finance. An IPO has a large number of financial intermediaries investing in the IPO. Therefore, the risk of failed investment is shared, thereby reducing the overall risk of an investing firm. On the other hand, the

issuing firm is not dependent on a single investor but has access to multiple sources, so the risk of not finding an investor is also reduced. The institutional investors can also choose to invest in a portfolio of multiple IPOs, thereby reducing their risk through diversification.

### **Cost Reduction**

Stringent market regulations ensure that to sell at the primary market businesses should meet financial and legal parameters. Businesses should also provide full disclosure of their financial structure through a prospectus that is available to all potential investors. Due to this, investors can accurately estimate whether the IPO price is fair. The primary market thus reduces “information costs”--the costs incurred in assessing the investment merit of the asset. The primary market also reduces “search costs”--the costs associated with time and money spent in locating potential investors and counterparty for trade.

### **Functions of Primary Market**



1. Origination
2. Underwriting
3. Distribution

### **Origination:**

Origination refers to the work of investigation and analysis and processing of new proposals. This in turn may be:

- A preliminary investigation undertaken by the sponsors (specialized agencies) of the issue. This involves a careful study of the technical, economic, financial and/legal aspects of the issuing companies to ensure that it warrants the backing of the issue house.
- Services of an advisory nature which go to improve the quality of capital issues. These services include advice on such aspects of capital issues as: determination of the class of security to be issued and price of the issue in terms of market conditions; the timing and magnitude of issues; method of flotation; and technique of selling and so on.

The importance of the specialized services provided by the New Issue Market organization in this respect can hardly be over-emphasized. On the thoroughness of investigation and soundness of judgment of the sponsoring institution depends, to a large extent, the locative efficiency of the market. The origination, however, thoroughly done, will not by itself guarantee success of an issue. A second specialized service i.e. “Underwriting” is often required.

### **Underwriting:**

The idea of underwriting originated on account of uncertainties prevailing in the capital market as a result of which the success of the issue becomes unpredictable. If the issue remains undersubscribed, the directors cannot proceed to allot the shares, and have to return money to the applicants if the subscription is below a minimum amount fixed under the Companies Act. Consequently, the issue and hence the project will fail.

Underwriting entails an agreement whereby a person/ organization agrees to take a specified number of shares or debentures or a specified amount of stock offered to the public in the event of the public not subscribing to it, in consideration of a commission the underwriting commission.

If the issue is fully subscribed by the public, there is no liability attaching to the underwriters; else they have to come forth to meet the shortfall to the extent of the under- subscription. The underwriters in India may broadly be classified into the following two types:

- (i) Institutional Underwriters;
- (ii) Non-Institutional Underwriting.

### **Institutional Underwriting:**

In our country has been development oriented. It stands as a major support to those projects which often fail to catch the eye of investing public. These projects rank high from the points of view of national importance e.g. steel, fertilizer, and generally receive higher priority by such underwriters.

Thus institutional underwriting may be broadly recognized, in the context of development credit, as playing a decisive role in directing the economic resources of the country towards desired activities.

This does not mean that they are barred entrance in the issue market from so called glamorous issues to which public can be expected to readily subscribe. They may be underwriting in such cases, but what is expected of them is their support to projects in the priority sector.

One of the principal advantages they offer is that resource-wise they are undoubted. They are in a position to fulfill their underwriting commitments even in the worst foreseeable situations.

The public financial institutions namely IDBI, IFCI, ICICI, LIC and UTI, underwrite a portion of the issued capital. Usually, the underwriting is done in addition to granting term finance by way of loans on debentures. These institutions are usually approached when one or more of the following situations prevail:

- (i) The issue is so large that broker-underwriting may not be able to cover the entire issue.
- (ii) The gestation period is long enough to act as distinctive
- (iii) The project is weak, inasmuch as it is being located in a backward area.
- (iv) The project is in the priority sector which may not be able to provide an attractive return on investment.
- (v) The project is promoted by technicians.
- (vi) The project is new to the market.

The quantum of underwriting assistance varies from institution to institution according to the commitments of each of them for a particular industry.

However, institutional underwriting suffers from the following two drawbacks:

1. The institutional handling involves procedural delays which sometimes dampen the initiative of the corporate managers or promoters.
2. The other disadvantage is that the institutions prefer to wait and watch the results to fulfill their obligations only where they are called upon to meet the deficit caused by under subscription.

### **Distribution:**

The sale of securities to the ultimate investors is referred to as distribution; it is another specialized job, which can be performed by brokers and dealers in securities who maintain regular and direct contact with the ultimate investors. The ability of the New Issue Market to cope with the growing requirements of the expanding corporate sector would depend on this triple-service function

### **Methods of Floating New Issues in the Primary Market**

- **Public issue:** When a company raises funds by selling (issuing) its shares (or debenture / bonds) to the public through issue of offer document (prospectus), it is called a public issue. **Initial Public Offer (IPO):** When a (unlisted) company makes a public issue for the first time and gets its shares listed on stock exchange, the public issue is called as initial public offer (IPO). **Follow-on public offer (FPO):** When a listed company makes another public issue to raise capital, it is called follow-on offer (FPO).

- **Offer for sale:** Institutional investors like venture funds, private equity funds etc., invest in unlisted company when it is very small or at an early stage. Subsequently, when the company becomes large, these investors sell their shares to the public, through issue of offer document and the company's shares are listed in stock exchange. This is called as **offer for sale**. The proceeds of this issue go to the existing investors and not to the company.
- **Private Placement:** The sale of securities to a relatively small number of select investors for raising capital. Investors involved in private placements are usually large banks, mutual funds, insurance companies and pension funds. Private placement is the opposite of a public issue, in which securities are made available for sale on the open market.
- **Issue of Indian Depository Receipts (IDR):** A foreign company which is listed in stock exchange abroad can raise money from Indian investors by selling (issuing) shares. These shares are held in trust by a foreign custodian bank against which a domestic custodian bank issues an instrument called Indian depository receipts (**IDR**). IDR can be traded in stock exchange like any other shares and the holder is entitled to rights of ownership including receiving dividend.
- **Rights issue (RI):** When a company raises funds from its existing shareholders by selling (issuing) them new shares / debentures, it is called as **rights issue**. The offer document for a rights issue is called as the **Letter of Offer** and the issue is kept open for 30-60 days. Existing shareholders are entitled to apply for new shares in proportion to the number of shares already held.
- **Bonus Issue,** the company issues new shares to its existing shareholders. As the new shares are issued out of the company's reserves (accumulated profits), shareholders need not pay any money to the company for receiving the new shares.

### Book Building

Book building is a price discovery mechanism that is used in the stock markets while pricing securities for the first time. When shares are being offered for sale in an IPO, it can either be done at a fixed price. However, if the company is not sure about the exact price at which to market its shares, it can decide a price range instead of an exact figure. This process of discovering the price by providing the investors with a price range and then asking them to bid on it is called the book building process. It is considered to be one of the most efficient mechanisms of pricing securities in the primary market.

Book Building may be defined as a process used by companies raising capital through Public Offerings-both Initial Public Offers (IPOs) and Follow-on Public Offers (FPOs) to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer. The process is directed towards both the institutional investors as well as the retail investors. The issue price is determined after the bid closure based on the demand generated in the process.

### Book Building Process

The detailed process of book building is as follows:

1. **Appointment of Investment Banker:** The first step starts with appointing the lead investment banker. The lead investment banker conducts due diligence. They propose the size of the capital issue that must be conducted by the company. Then they also propose a price band for the shares to be sold. If the management agrees with the propositions of the investment banker, the prospectus is issued with the price range as suggested by the investment banker. The lower end of the price range is known as the floor price whereas the higher end is known as the ceiling price. The final price at which securities are indeed offered for sale after the entire book building process is called the cut-off price.
2. **Collecting Bids:** Investors in the market are requested to bid to buy the shares. They are requested to bid the number of shares that they are willing to buy at varying price levels. These bids along with the application money are supposed to be submitted to the investment bankers. It must be noted that it is

not a single investment banker who is engaged in the collection of bids. Rather, the lead investment banker can appoint sub-agents to tap into their network especially for receiving the bids from a larger group of individuals.

3. **Price Discovery:** Once all the bids have been aggregated by the lead investment banker, they begin the process of price discovery. The final price chosen is simply the weighted average of all the bids that have been received by the investment banker. This price is declared as the cut-off price. For any issue which has received substantial publicity and which is being anticipated by the public, the ceiling price is usually the cut-off price.
4. **Publicizing:** In the interest of transparency, stock exchanges all over the world require that companies make public the details of the bids that were received by them. It is the lead investment banker's duty to run advertisements containing the details of the bids received for the purchase of shares for a given period of time (let's say a week). The regulators in many markets are also entitled to physically verify the bid applications if they wish to.
5. **Settlement:** Lastly, the application amount received from the various bidders has to be adjusted and shares have to be allotted. For instance, if a bidder has bid a lower price than the cut-off price then a call letter has to be sent asking for the balance money to be paid. On the other hand, if a bidder has bid a higher price than the cut-off, a refund cheque needs to be processed for them. The settlement process ensures that only the cut-off amount is collected from the investors in lieu of the shares sold to them.

#### NEW ISSUE BY EXISTING COMPANIES

- When a company is first formed, it will usually issue such number of shares as (when added to any sums it will borrow) will enable the company to start trading.
- Later, it may issue shares because it plans some new project or development that needs to be funded, or simply to grow the existing business.
- It may choose to issue shares in order to repay some of the company's borrowings.
- It may issue shares directly to the owner of a business that it wants to buy, as payment for that business (or issue shares to raise cash, which it then uses to pay for that business).
- It may issue shares to new employees that are taken on as 'employee shareholders'. Employees on employee-shareholder contracts are given shares in the business in exchange for giving up some of their employment rights.
- If it wants to buy all the shares in another company, it may issue shares to that company's shareholders as payment - in effect those shareholders swap their shares in the company that is being bought for shares in the company that is doing the buying.
- It may choose to make a bonus issue of shares to existing shareholders by using its own profits (which it could otherwise have paid to them in cash as dividends) to pay for new shares for them instead. This reduces the value of each share, making it more marketable, without the shareholders having to find new cash to pay for the shares. It can also be used to increase a private company's issued share capital to £50,000 (or its euro equivalent) so it can re-register as a public company.
- A company may give shareholders the choice of receiving a 'scrip' dividend of new shares rather than a cash dividend, reducing the drain on the company's cash reserves and suiting shareholders who have no need for a cash dividend.
- A company might also need to issue shares under the terms of any share options that had previously been granted.

#### Developments in the New Issue Market (NIM).

##### 1. Merchant Bankers

##### 2. Intermediaries

##### 3. Categories of Companies

#### **4. Application of Shares**

#### **5. Free Pricing of Issue**

#### **6. Issue Advertisement.**

##### *Development # 1. Merchant Bankers:*

One of the developments in the NIM was the role of intermediaries in selling 'new issues'. The role of the Merchant bankers was considered complementary to the NIM as they carry out all the activities relating to issue of shares. They draft prospectus, appoint registrars for share application and transfers, provide arrangements for underwriting, select brokers, bankers to the issue and handle past issue problems.

SEBI has made it mandatory for all firms issuing shares to appoint merchant bankers.

##### *Development # 2. Intermediaries:*

Another change in the NIM is with respect to intermediaries in the role of underwriters. Underwriting is no longer mandatory. Underwriters should have a certificate of registration with the SEBI and are governed by the rules and regulations of the SEBI. He has to abide by a code of conduct.

The third intermediary is the banker to the issue. He has also to be registered with the SEBI and has to pay fees of 2.5 lakhs for the first 2 years and Rs. 1 lakh for the third year. He has also to abide by the code of conduct laid down by the SEBI. Another intermediary, i.e., Brokers to the issue is extremely important in the stock market but it is not compulsory in the NIM.

An important activity in NIM which has been carried on after 1985 is to appoint Registrars and share transfer agents to an issue. The role of the registrars is extremely useful. They keep a record of the investor and assist companies for allotment of securities.

They despatch allotment letters, refund orders, certificates and other documents relating to the issue of capital. The transfer agents maintain records of holders of security and deal with transfers and redemptions of securities.

In Category I are placed those who are both Registrars and transfer agents and in Category II are those who are either transfer agents or Registrars. They must be compulsorily registered with the SEBI and the capital adequacy requirement in Rs. 6 lakhs for Category I and 3 lakhs for Category II.

They also have to maintain a code of conduct and act within the legal jurisdiction of the SEBI. A debenture trustee is also a necessary intermediary in the NIM. The debenture trustee has to be registered with SEBI. Only scheduled commercial banks, public financial institutions, insurance companies and companies are entitled to act as debenture trustees.

The registration fees for a debenture trustee are Rs. 2 lakhs for the first two years and 1 lakh for the third year. The role of debenture trustee is to look after the trust property and carry out all the activities for the protection of the debenture holders. Since the work requires integrity and fairness in discharging their duties, SEBI has a code of conduct for debenture trustees within which they have to carry out their duties.

The intermediaries have thus to follow a code of conduct, should fulfil capital adequacy norms and be disciplined in their dealing in the NIM. In case they do not follow the SEBI guidelines, their registration can be cancelled and they may be penalized by a penalty also.

##### *Development # 3. Categories of Companies:*

The SEBI has also made certain procedural changes in the mode of issue of capital for removing deficiencies in the issue procedure. Those companies which intend to issue capital have been classified into existing listed companies, existing unlisted companies and new companies. These are divided into 8 categories.

##### *Development # 4. Application of Shares:*

The application for shares is also made in accordance with SEBI guidelines. The minimum application money paid is 25% of the issue price. If the face value is Rs. 10, a minimum of Rs. 2.50 should be paid at the time of application of shares.

There should be a minimum of 30 collection centres at which money can be collected. The collection agents are authorized to collect application money by cheques or drafts but not in cash. The application money so collected should be deposited in the share application account with the authorized banker.

*Development # 5. Free Pricing of Issue:*

Keeping in view the changes in the capital market emanating from free pricing of shares and free access to market for funds by the issuers, the SEBI with the objective of broadening the investors' base, dispensed with the requirement of standard denomination of Rs. 10 and Rs. 100, gave freedom to companies with dematerialized shares, to issue shares at any denomination.

The existing companies, with shares at Rs. 10 and Rs. 100, also can avail of this facility by consolidating or splitting their existing shares.

In order to enable the investors to take informed investment decisions, the stock exchanges were directed to indicate the denomination value of shares as fixed by the company along with the market quotation. However, the companies availing of this facility are required to strictly adhere to disclosures and accounting norms.

SEBI also decided that there would be only one set of disclosures and entry norms for all the issues irrespective of the issue price. Thus, the different requirements for making issues at par and premium were merged to create a common set of requirement.

*Development # 6. Issue Advertisement:*

SEBI has issued guidelines regarding code of 'advertisement' for issue of shares. The statements in these advertisements should be clear and fair and not misleading and false. A new issue is required to be advertised in the newspapers and through brochures, pamphlets and circulars.

It can be advertised through radio and television and through hoardings at prominent places. The advertisement should be true and correct and full facts should be disclosed. It should not be a promise or a guarantee of any fact which is not present in the offer document.

Models and celebrities cannot be part of the advertisement displays. The advertisement should be released with risk factors.

**SEBI Guidelines for issue of fresh share capital**

1. All applications should be submitted to SEBI in the prescribed form.
2. Applications should be accompanied by true copies of industrial license.
3. Cost of the project should be furnished with scheme of finance.
4. Company should have the shares issued to the public and listed in one or more recognized stock exchanges.
5. Where the issue of equity share capital involves offer for subscription by the public for the first time, the value of equity capital, subscribed capital privately held by promoters, and their friends shall be not less than 15% of the total issued equity capital.
6. An equity-preference ratio of 3:1 is allowed.
7. Capital cost of the projects should be as per the standard set with a reasonable debt-equity ratio.
8. New company cannot issue shares at a premium. The dividend on preference shares should be within the prescribed list.
9. All the details of the underwriting agreement.
10. Allotment of shares to NRIs is not allowed without the approval of RBI.
11. Details of any firm allotment in favor of any financial institutions.
12. Declaration by secretary or director of the company.

**SEBI Guidelines for first issue by new companies in Primary Market:**

1. A new company which has not completed 12 months of commercial operations will not be allowed to issue shares at a premium.
2. If an existing company with a 5-year track record of consistent profitability, is promoting a new company, then it is allowed to price its issue.

3. A draft of the prospectus has to be given to the SEBI before public issue.
4. The shares of the new companies have to be listed either with OTCEI or any other stock exchange.

### **SEBI guidelines for Secondary market**

1. All the companies entering the capital market should give a statement regarding fund utilization of previous issue.
2. Brokers are to satisfy capital adequacy norms so that the member firms maintain adequate capital in relation to outstanding positions.
3. The stock exchange authorities have to alter their bye-laws with regard to capital adequacy norms.
4. All the brokers should submit with SEBI their audited accounts.
5. The brokers must also disclose clearly the transaction price of securities and the commission earned by them. This will bring transparency and accountability for the brokers.
6. The brokers should issue within 24 hours of the transaction contract notes to the clients.
7. The brokers must clearly mention their accounts details of funds belonging to clients and that of their own.
8. Margin money on certain securities has to be paid by claims so that speculative investments are prevented.
9. Market makers are introduced for certain scrips by which brokers become responsible for the supply and demand of the securities and the price of the securities is maintained.
10. A broker cannot underwrite more than 5% of the public issue.
11. All transactions in the market must be reported within 24 hours to SEBI.
12. The brokers of Bombay and Calcutta must have a capital adequacy of Rs. 5 lakhs and for Delhi and Ahmadabad it is Rs. 2 lakhs.
13. Members who are brokers have to pay security deposit and this is fixed by SEBI.

### **Types of mutual funds:**

#### **Open ended schemes**

An open-end fund is one that is available for subscription all through the year. This type of Mutual funds does not have a predefined maturity period. The key feature is liquidity. Direct dealing is another noticeable feature. One can easily buy and sell units at Net Asset Value related prices.

#### **Close ended schemes**

Here maturity period is predefined usually ranging from 2 to 15 years. Investment can be done directly in the scheme at the time of the initial issue and units can be brought and sold whenever units are listed in the stock exchanges.

### **Types of Schemes**

**1. Equity/growth oriented Funds:** Equity schemes are those that invest predominantly in equity shares of companies. An equity scheme seeks to provide returns by way of capital appreciation. As a class of assets, equities are subject to greater fluctuations. Hence, the NAVs of these schemes will also fluctuate frequently. Equity schemes are more volatile, but offer better returns.

**2. Balanced Funds:** The aim of balanced funds is to provide both growth and regular income. Such schemes periodically distribute a part of their earning and invest both in equities and fixed income securities in the proportion indicated in their offer documents.

**3. Index Funds:** An Index Fund is a mutual fund that tries to mirror a market index, like Nifty or BSE Sensex, as closely as possible by investing in all the stocks that comprise that index in proportions equal to the weight age of those stocks in the index.

**4. Income/debt oriented Funds:** These schemes invest mainly in income-bearing instruments like bonds, debentures, government securities, commercial paper, etc. These instruments are much less volatile than equity schemes. Their volatility depends essentially on the health of the economy e.g., rupee depreciation, fiscal deficit, inflationary pressure. Performance of such schemes also depends on bond ratings.

#### **1) Equity Funds**

As explained earlier, such funds invest only in stocks, the riskiest of asset classes. With share prices fluctuating daily, such funds show volatile performance, even losses. However, these funds can yield great capital appreciation as, historically, equities have outperformed all asset classes. At present, there are four types of equity funds available in the market. In the increasing order of risk, these are:

#### **a) Index funds**

These funds track a key stock market index, like the BSE (Bombay Stock Exchange) Sensex or the NSE (National Stock Exchange) S&P CNX Nifty. Hence, their portfolio mirrors the index they track, both in terms of composition and the individual stock weightages. For instance, an index fund that tracks the Sensex will invest only in the Sensex stocks. The idea is to replicate the performance of the benchmarked index to near accuracy. Index funds don't need fund managers, as there is no stock selection involved.

Investing through index funds is a passive investment strategy, as a fund's performance will invariably mimic the index concerned, barring a minor "tracking error". Usually, there's a difference between the total returns given by a stock index and those given by index funds benchmarked to it. Termed as tracking error, it arises because the index fund charges management fees, marketing expenses and transaction costs (impact cost and brokerage) to its unit holders. So, if the Sensex appreciates 10 per cent during a particular period while an index fund mirroring the Sensex rises 9 per cent, the fund is said to have a tracking error of 1 per cent.

To illustrate with an example, assume you invested Rs 1,000 in an index fund based on the Sensex on 1 April 1978, when the index was launched (base: 100). In August, when the Sensex was at 3,457, your investment would be worth Rs 34,570, which works out to an annualised return of 17.2 per cent. A tracking error of 1 per cent would bring down your annualised return to 16.2 per cent. Obviously, lower the tracking error, the better are the index funds.

#### **b) Diversified funds**

Such funds have the mandate to invest in the entire universe of stocks. Although by definition, such funds are meant to have a diversified portfolio (spread across industries and companies), the stock selection is entirely the prerogative of the fund manager. This discretionary power in the hands of the fund manager can work both ways for an equity fund. On the one hand, astute stock-picking by a fund manager can enable the fund to deliver market-beating returns; on the other hand, if the fund manager's picks languish, the returns will be far lower. Returns from a diversified fund depend a lot on the fund manager's capabilities to make the right investment decisions. A portfolio concentrated in a few sectors or companies is a high risk, high return proposition.

#### **c) Tax-saving funds**

Also known as ELSS or equity-linked savings schemes, these funds offer benefits under Section 88 of the Income-Tax Act. So, on an investment of up to Rs 10,000 a year in an ELSS, one can claim a tax exemption of 20 per cent from his taxable income. One can invest more than Rs 10,000, but then he won't get the Section 88 benefits for the amount in excess of Rs 10,000. The only drawback to ELSS is that one has to lock into the scheme for three years.

In terms of investment profile, tax-saving funds are like diversified funds. The one difference is that because of the three year lock-in clause, tax-saving funds get more time to reap the benefits from their stock picks, unlike plain diversified funds, whose portfolios sometimes tend to get dictated by redemption compulsions.

#### **d) Sector funds**

The riskiest among equity funds, sector funds invest only in stocks of a specific industry, say IT or FMCG. A sector fund's NAV will zoom if the sector performs well; however, if the sector languishes, the scheme's NAV too will stay depressed. Barring a few defensive, evergreen sectors like FMCG and pharma, most other industries alternate between periods of strong growth and bouts of slowdowns. The way to make money from sector funds is to catch these cycles—get in when the sector is poised for an upswing and exit before it slips back.

## **2) Difference between direct equity and mutual funds**

A mutual fund is the ideal investment vehicle for today's complex and modern financial scenario. Markets for equity shares, bonds and other fixed income instruments, real estate, derivatives and other assets have become mature and information driven. Price changes in these assets are driven by global events occurring in faraway places. A typical individual is unlikely to have the knowledge, skills, inclination and time to keep track of events, understand their implications and act speedily. An individual also finds it difficult to keep track of ownership of his assets, investments, brokerage dues and bank transactions etc.

Investing in Mutual Fund is convenient because of two basic reasons. All investment carry risks, especially equity investment that bears larger risks, their returns are more volatile and uneven. To cut down the risk one needs to put money in several instruments rather than in one or two products. A Mutual Fund can effectively spread its investments across various sectors of the economy and amongst several products. Risk diversification is the Key. Secondly 'where to invest and where not to', is a specialized business. One may not have the expertise, time and resources of a well-managed fund.

### **ADVANTAGES OF A MUTUAL FUND**

#### **1. Professional Management**

Qualified professionals manage money, but they are not alone. They have a research team that continuously analyses the performance and prospects of companies. They also select suitable investments to achieve the objectives of the scheme, so you see that it is a continuous process that takes time and expertise that will add value to investment. These fund managers are in a better position to manage investments and get higher returns.

#### **2. Diversification**

The cliché, "don't put all eggs in one basket" really applies to the concept of intelligent investing. Diversification lowers risk of loss by spreading money across various industries. It is a rare occasion when all stocks decline at the same time and in the same proportion. Sector funds will spread investment across only one industry and it would not be wise for portfolio to be skewed towards these types of funds for obvious reasons.

#### **3. Choice of Schemes**

Mutual funds offer a variety of schemes that will suit investors needs over a lifetime. When they enter a new stage in life, all needed to do is sit down with investment advisor who will help to rearrange portfolio to suit altered lifestyle.

#### **4. Affordability**

A small investor may find that it is not possible to buy shares of larger corporations. Mutual funds generally buy and sell securities in large volumes that allow investors to benefit from lower trading costs. The smallest investor can get started on mutual funds because of the minimal investment requirements. One can invest with a minimum of Rs. 500 in a Systematic Investment Plan on a regular basis.

#### **5. Tax Benefits**

Investments held by investors for a period of 12 months or more qualify for Capital gains and will be taxed accordingly (10% of the amount by which the investment appreciated, or 20% after factoring in the benefit of cost indexation, whichever is lower). These investments also get the benefit of indexation.

#### **6. Liquidity**

With open-end funds, you can redeem all or part of investment any time you wish and receive the current value of the shares or the NAV related price. Funds are more liquid than most investments in shares, deposits and bonds and the process is standardized, making it quick and efficient so that you can get cash in hand as soon as possible.

#### **7. Rupee Cost Averaging**

Through using this concept of investing the same amount regularly, mutual funds give investor the advantage of getting the average unit price over the long-term. This reduces risk and also allows you to discipline self by actually investing every month or quarterly and not making sporadic investments.

### **8. The Transparency of Mutual Funds**

The performance of a mutual fund is reviewed by various publications and rating agencies, making it easy for investors to compare one to the other. Once you are part of a mutual fund scheme, you are provided with regular updates, for example daily NAVs, as well as information on the specific investments made and the fund manager's strategy and outlook of the scheme.

### **9. Easy To Administer**

Mutual funds units in modern times are not issued in the form of certificates, with a minimum denomination rather they are issued as account statement with a facility to hold units in fraction upto 4 decimal points.

### **10. Highly Regulated**

The governing of mutual funds by SEBI ensures that the fund activities are carried out in the best interest of the investors.

## **DISADVANTAGES OF MUTUAL FUNDS**

The following are some of the reasons which are deterrent to mutual fund investment:

**Costs despite Negative Returns** — Investors must pay sales charges, annual fees, and other expenses regardless of how the fund performs. And, depending on the timing of their investment, investors may also have to pay taxes on any capital gains distribution they receive — even if the fund went on to perform poorly after they bought shares.

**Lack of Control** — Investors typically cannot ascertain the exact make-up of a fund's portfolio at any given time, nor can they directly influence which securities the fund manager buys and sells or the timing of those trades.

**Price Uncertainty** — with an individual stock, you can obtain real-time (or close to real-time) pricing information with relative ease by checking financial websites or by calling your broker. You can also monitor how a stock's price changes from hour to hour — or even second to second. By contrast, with a mutual fund, the price at which you purchase or redeem shares will typically depend on the fund's NAV, which the fund might not calculate until many hours after you've placed your order. In general, mutual funds must calculate their NAV at least once every business day, typically after the major U.S. exchanges close.