PAPER – 6B: FINANCIAL SERVICES AND CAPITAL MARKETS

Case Study 3

Recently SEBI has come out with a circular relating to categorization and rationalization of Mutual Fund Schemes. (The Extract of some of the relevant portion is as per Exhibit – 1).

Description of some of the existing schemes is given as per Exhibits 2 to 6.

Questions

(A) As per the circular, the existing 'type of scheme' would be replaced with type of scheme as applicable to each category of scheme. You are required to suggest the group in which each of the five existing schemes shall be re-categorized with brief reasons in the following format.

Source	Name of the Scheme as per the exhibit	Proposed Re-categorization		Reasons for such Re-categorization
Exhibit No.		Scheme	Category of Scheme	

(4 marks for each of the five schemes)

(B) A mutual fund raised ₹150 lakhs on April 1, by issue of 15 lakh units at ₹10 per unit. The fund invested in several capital market instruments to build a portfolio of ₹140 lakhs. Initial expense amounted to ₹8 lakhs. During the month of April, the fund sold certain securities costing ₹45.75 lakhs for ₹48 lakhs and purchased certain other securities for ₹42.4 lakhs. The fund management expenses for the month amounted to ₹6 lakhs of which ₹50,000 was in arrears. The dividend earned was ₹2 lakhs. 80% of the realized earnings were distributed. The market value of the portfolio on 30th April was ₹148.75 lakhs.

Suppose you as an investor subscribed to 1000 unit on April 1 and disposed it off at closing NAV on 30th April then what will be your annual rate of earning. ***(10 Marks)***

(C) Multiple Choice Questions

(i) In an open ended scheme, redemption period is ……….

a) Definite

b) Indefinite

c) 5 years

d) 10 years

(ii) Gilt Funds mainly invested in …………

a) Government Securities

b) Only in Debt Securities

c) Only in shares

d) Mix of debt and equity

(iii) ……… seeks to generate long term capital appreciation by investing in equity and equity related instruments including equity derivatives as well as debt instruments.

a) Focused Fund

b) Arbitrage Fund

c) Index Funds

d) Dynamic Equity Funds

(iv) ……….. is an offer document containing all the relevant details except that of price or number of shares being offered.

a) Letter of Offer

b) Draft Offer Document

c) Abridged Prospectus

d) Red Herring Prospectus

(v) Index value on a particular date is calculated as

a) Index on previous day x Total market capitalization for current day/Total market capitalization of the previous day

b) Index on current day x Total market capitalization for current day/Total market capitalization of the previous day

c) Index on previous day x Total market capitalization for previous day/Total market capitalization of the current day

d) Index on current day x Total market capitalization for previous day/Total market capitalization of the current day

(vi) While Sharpe ratio measures ………, the Treynor Ratio measures only the ………..

a) Total Risk; Systematic Risk

b) Unsystematic Risk; Systematic Risk

c) Systematic Risk; Unsystematic Risk

d) Systematic Risk; Total Risk

(vii) A bank rediscounted a commercial bill with a face of ₹100 @12% for 3 months. The sale value is ₹96.8. The yield to the investor will be

a) 15.39%

b) 14.08%

c) 13.22%

d) 12.80

(viii) Market Makers comprises of

a) Commercial Banks

b) Mutual Funds

c) Insurance Companies

d) All of the above

(ix) The risk which arises due to possible change in spreads is called

a) Optionality Risk

b) Repricing Risk

c) Yield Curve Risk

d) Basis Risk

(x) The role of ………. is responsible for the delivery and settlement and consequent accounting entries for all those transactions.

a) Front Office

b) Back Office

c) Mid-Office

d) Top Office

(10 x 2 = 20 Marks)

Exhibit 1

EXTRACTS FROM SEBI CIRCULAR

All Mutual Funds/Asset Management Companies (AMCs)/ Trustee Companies/Boards of Trustees of Mutual Funds/ AMFI

Sir/ Madam,

Subject: Categorization and Rationalization of Mutual Fund Schemes

1. It is desirable that different schemes launched by a Mutual Fund are clearly distinct in terms of asset allocation, investment strategy etc. Further, there is a need to bring in uniformity in the characteristics of similar type of schemes launched by different Mutual Funds. This would ensure that an investor of Mutual Funds is able to evaluate the different options available, before taking an informed decision to invest in a scheme.

2. In order to bring the desired uniformity in the practice, across Mutual Funds and to standardize the scheme categories and characteristics of each category, the issue was discussed in Mutual Fund Advisory Committee (MFAC). Accordingly, it has been decided to categorize the MF schemes as given below:

I. Categories of Schemes, Scheme Characteristics and Type of Scheme (Uniform Description of Schemes):

3. The Schemes would be broadly classified in the following groups:

a. Equity Schemes

b. Debt Schemes

c. Hybrid Schemes

d. Solution Oriented Schemes

e. Other Schemes

The details of the scheme categories under each of the aforesaid groups along with their characteristics and uniform description are given in the Annexure.

4. As per the annexure, the existing 'type of scheme' (presently mentioned below the scheme name in the offer documents/ advertisements/ marketing material/etc.) would be replaced with the type of scheme (given in the third column of the tables in the Annexure) as applicable to each category of scheme. This will enhance the existing disclosure. Hence, for the purpose of alignment of the existing schemes with the provisions of this circular, change in "type of scheme" alone, would not be considered as a change in fundamental attribute.

5. In case of Solution oriented schemes, there will be specified period of lock in as stated in the Annexure.

However, the said lock- in period would not be applicable to any existing investment by an investor, registered SIPs and incoming STPs in the existing solution oriented schemes as on the date on which such scheme is getting realigned with the provisions of this circular.

6. The investment objective, investment strategy and benchmark of each scheme shall be suitably modified (wherever applicable) to bring it in line with the categories of schemes listed above.

II. Definition of Large Cap, Mid Cap and Small Cap:

7. In order to ensure uniformity in respect of the investment universe for equity schemes, it has been decided to define large cap, mid cap and small cap as follows:

a. Large Cap: 1st -100th company in terms of full market capitalization

b. Mid Cap: 101st -250th company in terms of full market capitalization

c. Small Cap: 251st company onwards in terms of full market capitalization

8. Mutual Funds would be required to adopt the list of stocks prepared by AMFI in this regard and AMFI would adhere to the following points while preparing the list:

a. If a stock is listed on more than one recognized stock exchange, an average of full market capitalization of the stock on all such stock exchanges, will be computed;

b. In case a stock is listed on only one of the recognized stock exchanges, the full market capitalization of that stock on such an exchange will be considered.

c. This list would be uploaded on the AMFI website and the same would be updated every six months based on the data as on the end of June and December of each year. The data shall be available on the AMFI website within 5 calendar days from the end of the 6 months period.

9. Subsequent to any updation in the list, Mutual Funds would have to rebalance their portfolios (if required) in line with updated list, within a period of one month.

Annexures to the SEBI Circular

A. Equity Schemes:

Category of Schemes	**Scheme Characteristics**	**Type of scheme (uniform description of scheme)**
Large & Mid Cap Fund	Minimum investment in equity & equity related instruments of large cap companies- 35% of total assets. Minimum investment in equity & equity related instruments of mid cap stocks- 35% of total assets.	Large & Mid Cap Fund- An open ended equity scheme investing in both large cap and mid cap stocks
Small cap Fund	Minimum investment in equity & equity related instruments of small cap companies- 65% of total assets	Small Cap Fund- An open ended equity scheme predominantly investing in small cap stocks
Dividend Yield Fund	Scheme should predominantly invest in dividend yielding stocks. Minimum investment in equity- 65% of total assets	An open ended equity scheme predominantly investing in dividend yielding stocks
Focused Fund	A scheme focused on the number of stocks (maximum 30) Minimum investment in equity & equity related	An open ended equity scheme investing in maximum 30 stocks (mention where the scheme intends to focus, *viz.,* multi

	instruments - 65% of total assets	cap, large cap, mid cap, small cap)

B. Debt Schemes

Category of Schemes	Scheme Characteristics	Type of scheme (uniform description of scheme)
Ultra Short Duration Fund	Investment in Debt & Money Market instruments such that the Macaulay duration of the portfolio is between 3 months - 6 months	An open ended ultra-short term debt scheme investing in instruments with Macaulay duration between 3 months and 6 months.
Low Duration Fund	Investment in Debt & Money Market instruments such that the Macaulay duration of the portfolio is between 6 months- 12 months	An open ended low duration debt scheme investing in instruments with Macaulay duration between 6 months and 12 months.
Money Market Fund	Investment in Money Market instruments having maturity upto 1 year	An open ended debt scheme investing in money market instruments

C. Hybrid Schemes

Category of Schemes	Scheme Characteristics	Type of scheme (uniform description of scheme)
Dynamic Asset Allocation or Balanced Advantage	Investment in equity/ debt that is managed dynamically	An open ended dynamic asset allocation fund
Arbitrage Fund	Scheme following arbitrage strategy. Minimum investment in equity & equity related instruments- 65% of total assets	An open ended scheme investing in arbitrage opportunities

D. Solution Oriented Schemes:

Category of Schemes	Scheme Characteristics	Type of scheme (uniform description of scheme)
Retirement Fund	Scheme having a lock-in for at least 5 years or till retirement age whichever is earlier	An open ended retirement solution oriented scheme having a lock-in of 5 years or till retirement age (whichever is earlier)
Children's Fund	Scheme having a lock-in for at least 5 years or till the child attains age of majority whichever is earlier	An open ended fund for investment for children having a lock-in for at least 5 years or till the child attains age of majority (whichever is earlier)

E. Other Schemes:

Category of Schemes	Scheme Characteristics	Type of scheme (uniform description of scheme)
Index Funds/ ETFs	Minimum investment in securities of a particular index (which is being replicated/ tracked)- 95% of total assets	An open-ended scheme replicating/ tracking index
FoFs (Overseas/ Domestic)	Minimum investment in the underlying fund- 95% of total assets	An open ended fund of fund scheme investing in fund.

Exhibit 2

Dream Venue Focused 25 Fund Regular Plan

A newbie entrant, Dream Venue Focused 25 Fund Regular Plan has nevertheless managed an impressive show for the last three years. Strong outperformance of the benchmark and category has allowed it to debut in the rating scale with a four-star rating in 2016 and climb to five stars recently.

Following the 'buy right, sit tight' philosophy of this fund house, this fund aims to own compact portfolios of quality stocks with secular long-term growth prospects, with low portfolio churn. The fund prefers to restrict its holdings to not more than 30 companies. It presently has 19 stocks in its portfolio. Furthermore, the fund has minimum investment in equity and equity related instruments upto 65%

While it seldom takes cash calls, it has a slightly higher preference for mid-cap stocks than peers in this category. In the last one year, its large-cap allocation has hovered at 80-90 per cent, while mid caps have accounted for 10-20 per cent.

The fund's track record is as yet too limited to draw conclusions about performance. For one year, the returns are a good 5 percentage points more than the benchmark returns and 3 percentage points more than the category returns. On a three-year basis, the margins are 8 and 5 percentage points, respectively. However, the fund is yet to encounter hostile markets like 2008 or even 2011 and hence its ability to manage choppy or falling markets is as yet untested.

A fund worth watching in the large-cap space.

Exhibit 3

Dream Venue Ultra Short Term Bond Fund - Regular Plan

The Open Ended ultra-short Scheme seeks to generate optimal returns consistent with moderate levels of risk and liquidity by investing in debt securities and money market securities such that the Macaulay Duration of the portfolio is between 6 – 12 months. The Scheme seeks to generate optimal returns consistent with moderate levels of risk and liquidity by investing in debt securities and money market securities

Exhibit 4

Dream Venue Dynamic Equity Fund - Regular Plan

The scheme seeks to generate long term capital appreciation by investing in equity and equity related instruments including equity derivatives as well as debt instruments. The basic purpose of the scheme is to invest in equity/debt that is managed dynamically. In other words, it is an open ended dynamic asset allocation fund.

The investment objective is to generate long term capital appreciation by investing in equity and equity related instruments including equity derivatives, debt, money market instruments and units issued by REITs and InvITs. However, there can be no assurance or guarantee that the investment objective of the Scheme would be achieved

Exhibit 5

CFDH RSF

Let’s take a look at the newest retirement fund, CFDH RSF. This fund’s equity plan, which comes with a five-year lock-in period, is similar to an ELSS fund. “Since ELSS, with a lower lock-in period of three years, is available, why go for a scheme with a higher lock-in period and also a 1% exit load, if redeemed before the age of 60,” asks Jeewan Kumar, CEO, South Asia Capital. Such products are also costlier because of their small size—small schemes charge a higher expense ratio. Except for ITU RBP, other schemes have much smaller assets under management (AUM). FIPF’s AUM, for instance, is just Rs 339 crore. The expense ratio of these products will be higher than the national pension scheme (NPS) but cheaper than insurance products.

The main advantage of mutual funds’ retirement products is that you don’t have to buy an annuity, as is the case with the NPS or pension plans from insurance companies. Instead, you can opt for a systematic withdrawal plan to meet your regular cash flow needs. Since a part of the withdrawal is your principal, it will be more tax-efficient as well.

Also, while the NPS restricts your equity exposure to 50%, with mutual fund products such as the CFDH RSF, you can take a 100% equity exposure. However, these products do not come with the additional Rs 50,000 in deduction, available to NPS. Mutual funds have asked for the extra tax benefit to be extended to their products, but whether or not this happens, will be known only when the Budget is presented on 29 February.

Mutual funds' pension products also offer greater liquidity, compared with the NPS or products from insurance companies. You can withdraw your accumulated corpus after the lock-in period— 3-5 years—is over. You may have to, however, pay a small exit load, if you want to withdraw your corpus but have not reached the retirement age—58 or 60, depending on the product. Calculating the lock-in period also varies across funds. For instance, in the case of HDFC RSF, the lock-in for each instalment is calculated from the date of investment. So, the money you invest at the age of 59 can be withdrawn only at the age of 64.

Exhibit 6

ITU Nifty Index Funds

The principal investment objective of this scheme is to invest in stocks of companies comprising S&P CNX Nifty Index and endeavour to achieve return equivalent to Nifty by passive investment The scheme is managed by replicating the index in the same weightage as in the S&P CNX Nifty-Index with the intention of minimising the performance differences between the scheme and the S&P CNX-Nifty Index in capital terms, subject to market liquidity, costs of trading, management expenses and other factors which may cause tracking error. The scheme alters the scrips/weights as and when the same are altered in the S&P CNX-Nifty Index.