# Why an investment in mutual funds can serve investor interests well

## With the safety of principal guaranteed, plus the added advantage of capital appreciation together with income earned in the form of interest or dividend, Shamin Sookia, Managing Director at Perigeum Capital Ltd, tells us why mutual funds are becoming one of the most sought-after asset classes for retail investors.

The mutual fund industry has been growing rapidly over the recent decades and this is reflected in the increase in assets under management of various funds worldwide.

Mutual funds provide a platform for a common investor to participate in the capital market with professional fund management irrespective of the amount invested. Furthermore, mutual fund investment is less risky than directly investing in stocks and is therefore a safer option for risk-averse investors.

It will be good to understand the factors affecting investment decisions in mutual funds and why retail investors prefer investing in these sound financial instruments as opposed to other types of products.

### Through the centuries: Tracing the genesis of mutual funds

Although historians may differ on the exact genesis of mutual funds, the origin of mutual funds can be traced back to a little more than a century and a half ago. In 1822, King William of the Netherlands formed Société Générale de Belgique in Brussels, which appears to be the first mutual fund and is the reason why many consider the Dutch as the early innovators who created the first closed-end investment companies.

However, mutual funds did not really capture the attention of American investors until the 1980s and 1990s, when investors hit record highs and realised incredible returns. They are now mainstream investments and form the core of individual retirement accounts. Having said that, the idea of pooling assets for investment purposes has been around for centuries. While the first modern mutual fund was launched in the US in 1924, with fund holdings now accounting for trillions of dollars in the US alone, the evolution of this type of investment vehicle has undergone many changes in recent decades.

Subhamoy Das, in his economics textbook "Perspectives on Financial Services," traces an early appearance of the mutual fund to Dutch merchant Adriaan van Ketwich, who created an investment trust in 1774. "Van Ketwich probably believed that diversification would appeal to investors with minimal capital. The name of van Ketwich's fund, Eendragt Maakt Magt, translates into 'unity creates strength,'" the book explains.

Other examples followed, including an investment trust launched in Switzerland in 1849 and similar vehicles formed in Scotland in the 1880s. The idea of pooling resources and spreading risk using closed-end investments found its way to the US by the 1890s. The Boston Personal Property Trust, formed in 1893, was the first closed-end fund in the US. According to Collins Advisors, the investments were primarily in real estate and the vehicle would be described as a hedge fund rather than a mutual fund in today's common parlance.

### Why mutual funds are still going strong

The impressive growth in the mutual funds industry in recent years can largely be attributed to various factors such as rising household savings, comprehensive regulatory framework, favourable tax policies, and introduction of several new products, investor education campaign and role of distributors.

**By Shamin A. Sookia, Managing Director, Perigeum Capital Ltd**

The driving force of mutual funds is the safety of principal guaranteed, plus the added advantage of capital appreciation together with income earned in the form of interest or dividend.

People prefer mutual funds to bank deposits, life insurance, bonds, because with little money they can get into the investment game. Mutual funds act as a gateway to enter into big companies hitherto inaccessible to an ordinary investor with his small investment. In financial markets, expectations of investors play a vital role and influence the price of securities, the volume traded, and also determine quite a lot of things in actual practice. Expectations of investors are influenced by their perception and humans generally relate perception to action.

It is widely believed that mutual funds are a type of retail product designed to target small investors, salaried people and others who are intimidated by the stock market but, nevertheless, like to reap the benefits of stock market investing. At the retail level, investors are unique and are a highly heterogeneous group.

Lonnie L. Bryant and Hao-Chen Liu published a research paper "Mutual fund industry management structure, risk and the impacts to shareholders" published in Global finance journal (2011) - the paper investigates the effects of a multiple fund management structure on the risk volatility of the funds managed with the help of the Sharpe ratio. Using a sample of 1480 funds managed by 407 managers, the impact that mutual fund management structure has on fund risk volatility was analysed and it was gleaned that the multiple fund management structures appear to be motivated by the need to achieve economies of scale and reduce shareholders' costs. Another survey of individual investors with the objective to find out what information source investors would normally rely upon revealed that there are economical, sociological, and psychological factors which control investment decisions.

While the main factors influencing investment decisions of retail investors in mutual funds are tax benefits, high returns, price and capital appreciations, other factors such as liquidity, diversification, risk, and brand image are also equally important in the eyes of the individual investor. Prospective retail investors seem to seek expert advice and rely mostly on it while making their investment decisions as opposed to some investors who are rather bent on

analysing past performance based on metrics like EBIT, Net Asset Values, and so on. Information about the performance of various mutual funds is mainly gathered from brokers, financial consultants, financial institutions, the internet, TV channels, finance & investment magazines and newspapers.

### The jury is out...

On balance, investors seeking to commit capital to this asset class must weigh all pros and cons carefully. The factors that would prevent investors from investing in mutual funds are bitter experience, difficulty in selection of appropriate schemes, lack of

> Mutual funds allow entry into big companies hitherto inaccessible to ordinary investors

confidence in services being provided by inefficient investment advisers and lack of knowledge. The factors that are seen to entice investors to invest in mutual funds are accruing tax benefits, return potential, liquidity, low cost, transparency, and economies of scale to a certain extent.

While equity-based schemes are the most preferred option, mutual funds have emerged as one of the most important classes of financial instruments which caters for the needs of retail investors in general, with the added benefits of price and capital appreciation.