

Scenario of Mutual Fund Industry in Nepal: A Discussion

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ABSTRACT

Mutual funds are becoming one of most popular investment avenues for small and risk averse investors. Mutual funds have become mainstream investments around the globe, but its presence is trifling in the Nepalese market. In Nepal the market for mutual funds is very lean and mutual fund as a most preferable instrument for investment is yet to be accepted by investors. The operation of mutual funds in Nepal is very limited in its scope and size.

The Nepalese mutual fund industry has not performed well in gaining the small individual investors' confidence and trust by offering better product, process, and services. Mutual fund is required to become popular either among high and middle income class people of urban zones. The current study has attempted to examine these problems in mutual funds operation in Nepal and it also attempts to identify impediments and prospects of mutual funds in Nepal. Mutual funds operation can be an integral part of the Nepalese financial system. Existing mutual fund institutions have to improve quality of service by using better technology and more focus on quick dissemination of information. Investors in Nepal can take mutual funds as a substitute of fixed deposits in banks rather than as an investment avenue in security market.

Keywords: Mutual Funds, Mainstream, Subscription, Portfolio, Regulation

Introduction

Mutual fund emerged as one of the most popular financial instruments for investment in the stock market worldwide during the period of twenty first century. In Nepal, the market for mutual funds is very lean and mutual fund as a most preferable instrument for investment is yet to be accepted by investors. The operation of mutual funds in Nepal is very limited in scope and its size. The effective institutional investment mechanism in Nepal is yet to be developed, to support the financing of large scale infrastructure project. The current study has attempted to examine these problems in mutual funds operation. The Nepalese mutual fund industry has not performed well in gaining the small individual investors confidence and trust by offering better product, process, and better services. Mutual fund is yet to become popular among high and middle income class people of urban zones. Foreign investors are yet to enter in the Nepalese market. Individual investors lack the sophistication or the information they need to make certain investment decisions. In this context, mutual funds can be an attractive avenues of investment in Nepalese capital market.

People could find the mutual fund investment so much interesting because of its high rate of return and diversification of risk associated with the

investment. But, in reality this scope of high rate of returns is just one side of the coin. On the other side, there is the harsh reality of highly fluctuating rate of returns. For the purpose to overcome the existing deficiency of mutual fund in Nepal there is an urgent need to establish effective institutional investment mechanism. Mutual fund can be the best solution to address the financial need of infrastructure projects. Yet the availability of research that offers a professional opinion of what may lie ahead for a mutual fund investment in the future is lacking until now in Nepalese context.

Objectives of the Study

The broad objective of the study is to examine the current status of Mutual funds and their prospects in Nepal. The specific objective of the study is to examine and analyze current status and performance of NCM mutual fund and Citizen Unit Scheme in Nepal. The current study has attempted to explore current problems of mutual funds in Nepal. Further, the study attempted to identify impediments and prospects of mutual funds in Nepal. The policy implications of the study are also devised. The study further aims to examine existing regulatory and operational mechanism of mutual funds in Nepal.

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Research Methodology

This study primarily has adopted descriptive research method. The study has undertaken the use of statistical tools including mean, standard deviation and correlation. The main goal of the current research is to describe the data (i.e. facts and figures) and its characteristics. The idea behind this research is to analyze and explore the current status of mutual fund investment in Nepal. The Descriptive research design has applied to explain the facts and gain a better understanding of a mutual fund in Nepal. The current study is entirely based on the secondary data and review of the related reports, articles and other publications. This paper has used the required data and literature from the annual reports and other publications of Citizen Investment Trust (CIT), NIDC Capital Markets, annual report of Security Board of Nepal, publications of Securities Board of India (SEBI), National Investment Trust Limited Pakistan and Unit Trust of India (UTI). Investment company institute, European fund and asset management association were also consulted as a source of secondary data. Articles published in national and international journals were reviewed and examined. The study has reviewed and examined the various governmental and non governmental reports published in between 1965 to 2010. Nepalese mutual fund industry data were collected from FY 2004/05 to 2008/09 and data on Asia /Pacific and global mutual funds were available till the date of June 30, 2006.

Literature Review

The empirical study on mutual funds is yet to be initiated in Nepal. Some of the empirical studies shed light on different dimension of mutual funds across the globe. McDonald (1974) examined the performance of funds, during the period from 1960 to 1969, and found that the fund objectives did explain a portion of performance as measured by excess returns over the market return. However, he also found large overlaps in performance from objective to objective. The performance measures of Treynor (1965), Sharpe (1966), and Jensen (1968) also ranked the objectives in the same order. Martin, Keown, and Farrell (1982) concluded that fund objectives explained only about 15 percent of the total variation in returns that was due to extra-market factors. The studies by Reints and Vandenberg (1973), Klemkosky (1976), and Woerheide (1989) showed mixed results for the strength of the relationship between performance

measures and the objective classifications, but in general there appeared to be a significant relationship. Davanzo and Nesbitt (1987), conducted study on the performance fees for investment management and observed that, the manger receives bonuses as the portfolio return begins to rise above an agreed-upon benchmark return. Baumol et al. (1990) noted that the primary service supplied by mutual fund advisors under advisory contracts was portfolio management. Daniel et al. (1997) found evidence that aggressive growth and growth fund advisors have some ability to generate excess returns. They found that, fund managers could generate additional performance if size, book to market, or momentum strategies had time varying expected returns that the manager could exploit by changing portfolio weights to exploit those styles when they are the most profitable. Edelen (1999) argued that better informed advisors majorly engage in information motivated trading. Khorana (1996) found that equity funds are more volatile than debt funds and the foreign funds are more volatile than domestic funds. Lu Zheng, (1999) summarized his findings that, investors do display fund selection ability, because the evidence shows that the positive portfolios outperform the negative portfolios.

Regulatory and Operational Mechanism of Mutual Funds in Nepal

Current provision of collective investment scheme has been mentioned in the Section 71 of Securities Act, 2007. It has clearly been stated in the Securities Act that no collective investment scheme shall be operated without obtaining a permission of SEBON. Some provision has further been stated in the Act that SEBON can grant permission to operate collective investment scheme if following conditions prevail, (Securities ACT 2007). A scheme manager shall, prior to operating the collective investment scheme to be managed and operated by him/her, make an application to the Board in such format and accompanied by such details and fees as may be prescribed in order to register such scheme with the Board and obtain permission to operate the same. Section 71 of the Act further stated that if, in conducting an inquiry in relation to the registration of a collective investment scheme and granting a permission to operate it, Board can demand notice, description, information or documents from the concerned scheme manager. The Board shall not grant permission to operate the collective investment scheme unless it receives the notice, description, information or documents so demanded. In addition, section 73 of the

Act states about the operation of collective investment scheme. The scheme manager may, with a view to operate a collective investment scheme, and having regard to the needs and interests of participants, operate the collective investment scheme of one or several types and by one or several names as prescribed, (securities Act 2007). The provision of collective investment scheme in the securities Act 2007, has granted authority to operate the existing mutual fund scheme in Nepal. Globally mutual fund is evolving as a separate industry, considering the above facts recently SEBON has formulated the drafts of Mutual Fund Regulation 2066. Ministry of Finance need to rethink giving the final shape to the Trust Act as well as Central Depository Act as soon as possible to operate the up coming Central Depository System (CDS) in Nepalese Capital Market. Trust Act and Central Depository Act must come into effect before any company can operate mutual funds in Nepal, The provision of Mutual Fund Regulation 2066 intends to avoid four-decade long restriction on Nepali investors going abroad. The government is currently shaping the draft of Mutual Fund Regulation to permit Nepalese mutual funds to be invested in the foreign capital market. When the mutual fund regulation materialized, institutional investors from Nepal can invest in foreign capital markets. According to the proposed regulation, a maximum of 25 percent of the paid-up capital of mutual funds can be invested in foreign capital markets. This can be a way forward in the Nepalese history of international portfolio investment.

Status of Mutual Funds in Nepal

In Nepal, the institutional investor base is small. At the same time, individual investors lack the sophistication to make some investment decisions and the amount and quality of information available to them is limited. NCM Mutual Fund is the only mutual fund in the country. It had been unable to expand because the government had not come out with the necessary laws. NIDC Capital Markets Ltd issued Nepal's first and only mutual fund namely NCM mutual fund, at a subscription price of Rs.10 per unit, which was extremely popular among the investors. The fund also played dominant role in the secondary capital market, buying and selling various stocks. During that period market capitalization of NCM mutual fund were Rs. 280,000,000, while closing market price of the unit was Rs. 28, (www.nepalstock.com). Concentrating on credit quality, sector selection, relative value and strategic duration management, NCM Capital formulates fixed income portfolios to satisfy clients'

investment objectives and internal policy guidelines. Each fixed income discipline aims to outperform its benchmark over a three- to five-year period. Between March 1 to April 30, 2010, NCM Mutual Fund (NCMMF) traded the highest number of shares amongst all the finance companies whose shares were traded in Nepal Stock Exchange (NEPSE) during the period (www.nepalstock.com). Citizen Investment Trust Act 1990 gave birth to the Citizen Investment Trust (CIT). The areas of activities of CIT are the operation of retirement schemes, unit trust schemes (a prospective mutual fund scheme) and the capital market services. Currently, there are two relatively small investment funds that are available to mobilize the savings of small investors. CIT, in addition to funds collected through the Citizen Unit Scheme, collects funds from other plans. It is operating the Increment Approved Retirement Fund, Gratuity Fund Scheme, Investor Accounts Scheme, Insurance Fund Scheme, Defined Contribution Pension Plan etc. The total fund collected during the first nine months of FY2007/08 stood at Rs. 9.168 billion. Unit Trust Schemes (UTS) has invested additional amount of Rs. 4.985 billion in the FY 2008/09, making its total loan portfolio management reach to Rs.14.011 billion. UTS portfolios consists of 11.63 percent in the Government Treasury Bonds and other fixed interest bearing instruments; 10.45 in periodic loans; 1.89 percent in share investment of companies; 9.45 percent in preference shares and debentures of companies; 11.0 percent on participants lending and home loans; and the remaining 55.57 in the fixed deposit accounts, (CIT Annual Report, 2008/09). Employees Provident Fund and was established under the Employees' Provident Fund Act of 1962. The Employees' Provident Fund (EPF) is an autonomous corporate body with perpetual succession. If utilised in an effective manner, the pool of savings available to the EPF could serve as an engine for economic growth. At the present time, most of the assets of the EPF are invested in deposits with state-owned banks and Government bonds. About 60 percent of fund assets are invested in bank deposits, 30 percent in Government bonds while the remaining 10 percent is in other investments, including syndicated bank loans with maturities of up to eight years. Thus the Funds still has not been an important source of long-term capital mobilization for private sector development. EPF can think of working as a prospective mutual fund institution in Nepal and can mobilize its large amount of idle deposits.

Status of Mutual Funds in India

Viswanadham (2007) stated that mutual fund is a mechanism for pooling the resources by issuing units to the public and investing funds in securities in accordance with objectives as disclosed in the offer document. The concept of mutual funds was introduced in India with the formation of Unit Trust of India in 1963. The government of India set up Unit Trust of India (UTI) in 1963 by an act on parliament, (www.utimf.com). UTI functioned under the regulatory and administrative control of the Reserve Bank of India till 1978. In 1995, the RBI permitted private sector institutions to set up Money Market Mutual Funds (MMMFs). Private institutions can invest in treasury bills, call and notice money, commercial paper, commercial bills accepted/co-accepted by banks, having unexpired maturity up to one year. The mutual funds industry in India has steadily grown over the decade. The mutual fund collects money directly or through brokers from investors. The money is invested in various instruments depending on the objective of the scheme. UTI Mutual Fund adopted approach of giving and equal importance to asset allocation and sectoral allocation, in security selection while managing any fund, as an investment strategy. Top-down and bottom-up approaches are combined by UTI to enable the portfolios/funds to adapt to different market conditions so as to prevent missing an investment opportunity.

Status of Mutual Funds in Pakistan

As stated in the study of Sohail Yaqoob (2006), government of Pakistan established National Investment Trust Limited (NITL) in 1962 which launched first Open End Equity Fund in Pakistan NIT. The National Investment (Unit) Trust is Pakistan's largest and oldest Mutual Fund, having approximately 56,000 unit holders. NIT's distribution network comprises of 19 NIT branches, various authorized bank branches all over Pakistan and Arab Emirates Investment Bank (AEIB) in Dubai (UAE). The National Investment (Unit) Trust is Pakistan's largest and oldest Mutual Fund. As on June 30, 2009, NIUT had funds under management of around Rs. 28 billion invested in over 430 listed companies, (www.nit.com.pk). Government of Pakistan established Investment Corporation of Pakistan (ICP) in 1966, which launched series of Closed End Funds. During the period of 1994-95 many more funds launched in private sector. As of 2006 the size of mutual fund industry was of 171 billion of Pakastani Rupees, (Yaqoob, 2006).

Table 1 . Analysis of Status of Asia/Pacific Mutual Fund Industry ,
As on June 30, 2006, Value at Million US \$

Asia Pacific Mutual Fund	No of Total FundsAssets	Total US \$	% of Total Assets
Australia		762724	34.62
Japan	2678	514024	23.33
Hong Kong	1067	545181	24.75
Republic of Korea	7653	228277	10.36
Taiwan	458	57301	2.60
India	467	50280	2.28
Malaysia	372	30068	1.36
New Zealand	586	10844	0.49
Pakistan	53	2833	0.12
Philippines	34	1116	0.05
Total	13368	2202648	100

Source: Investment Company Institute, European Fund and Asset Management Association

Table 1 reveals that the Mutual Fund Industry size of Asia/Pacific is growing rapidly. Larger proportion (i.e. 34.62 percent) of mutual fund assets was owned by Australia. And Japan was the second largest country which owned 23.33 percent of mutual fund assets followed by Hong Kong. Despite of large sized economy of India it holds only 2.28 percent of assets of Asia/Pacific Mutual Fund Industry. This reveals that India is yet to gain its momentum on mutual fund industry.

Analysis of Worldwide Mutual Fund Industry

Gurusamy (2004) stated that mutual funds in Japan and the Far East have been showing good performance, probably as a result of growth and performance of economies of these countries and their capital markets. Similarly, countries in the Pacific like Hong Kong, Thailand, Singapore, and Korea have also entered this field in a big way. Mauritius and the Netherlands are emerging as tax heavens for offshore mutual funds. Mutual funds are thus a global financial culture. First modern day mutual fund was opened in North America in 1924, The great depression of 1930s in USA has stalled the growth of mutual funds sector, like many other economic activities. Yet it was, 1990s that mutual funds became mainstream investments in the USA and around the globe. At the end of June, 2006, total mutual

fund assets all over the world were of US\$ 19.413 trillion.

Table 2 . Status of World Wide Mutual Fund Market
As on June 30, 2006, Value at Million US \$

World Mutual Fund Assets	No of Funds	Total Assets	Percentage of Total Assets
USA	7992	9337218	48.00
Europe	31541	6866033	35.36
Asia Pacific	12943	2169139	11.11
Africa	679	63480	3.20
Other America	6230	977709	5.00
Total	59385	US\$ 19413579	100.00

Source: Investment company institute, European fund and asset management association and other national fund association

Empirical Analysis of Mutual Funds in Nepal

Table 3 presents the operational performance during the period of FY 2005/06 to 2008/09, of Citizen Unit Scheme in column A and NCM Mutual Fund in column B.

Column A of above table reveals the size of investment of CUS in government bond, bank deposit, shares and debenture and loans and advances. Of the total investment of CUS, bank deposit holds the larger portion of investment followed by government bonds and loans and advances. Investment in shares and debenture has got least priority. The above trend of investment of CUS fund indicates that shares and debenture investment in Nepal is yet to be attractive, which may be due to absence of professional portfolio management, tax implications and inadequate government regulations. Column B of above table reveals that the larger proportion of investment of NCM fund is invested in shares and debenture, loan and advances holds second preference, followed by bank deposit and government bond. This reveals that NCM fund is more risky in comparison to CUS. NCM was allowed to begin its operation in 1991 on a contractual basis without any specific regulations. It can be said that NCM is unable to expand its scope of operation because the government is yet to come out with the necessary laws.

Table 3. Operational performance of Citizen Unit Scheme and NCM Mutual Fund

Details \ Fiscal Year	A. Citizen Unit Scheme (CUS) Rs. In Million				B. NCM Mutual Fund Rs. In Million			
	2005/06	2006/07	2007/08	2008/09	2005/06	2006/07	2007/08	2008/09
Investment	657.5	752.2	804.78	670	210.71	198.3	194.78	151.53
(a) Government Bond	173.9	93.2	93.2	70	10	10	10	10
(b) Bank Deposit	317.5	490.6	529.5	392.84	13.68	93.3	81.93	16.34
(c) Share / Debenture	26.5	28.9	42.59	67.6	183.53	86	88.95	90.8
(d) Loan & Advances	139.6	139.5	139.56	139.56	0	0	0	0
Net Income	50.4	49	65	42.7	13.89	23.2	47.68	34.25
Dividends (%)	7	6.25	6.25	6.25	8	8	15	15
Number of Unit Holders	2840	2840	2426	205	2481	2417	2950	2951
(a) Individual	2747	2747	2323	1947	2461	2397	2930	2931
(b) Institutional	93	93	103	103	20	20	20	20
Total amount of units sold	148.63	170.23	1980.03	2262				
Total amount of units repurchased	82.9	100.41	200.22	173.6				
Net Assets Value					189.14	314	488.88	536.85
Net Asset Value per unit (Rs.)					18.91	31.4	48.89	53.69
Per unit Market Price (Rs.)					11		24	24

Source: CIT and NCM Annual Report 2005/06- 2008/09

Table 4. Statistics of CUS and NCM Mutual Fund

Mutual fund Details	Result of FY 2005/06 to 2008/09				CUS and NCM Correlation
	Citizen Unit Scheme		NCM Mutual Fund		
	SD	Mean	SD	Mean	
Investment	69.82	721.12	25.78	188.83	0.2419
(a) Government Bond	45.54	107.57	0	10	NA
(b) Bank Deposit	95.88	432.61	42.18	51.31	0.9166
(c) Share / Debenture	18.85	41.39	47.51	112.32	0.4925
(d) Loan & Advances	0.04	139.55	NA	NA	NA
Net Income	9.43	51.77	14.56	29.75	0.5734
Dividends (%)	0.37	6.43	4.04	11.50	0.5773

Source: Compiled with the help of CIT and NCM Annual Report 2005/06- 2008/09.

Standard deviation as a proxy for risk, although it is really something slightly different: a measure of volatility, the variability of CUS investment has ranged from a low of 0.41 % (loans and advances) to a high of 95.88 % (Bank Deposit). The variability of NCM investment has ranged from a low of 0 % (Government bond) to a high of 47.51 % (shares and debentures). From the analysis of correlation coefficient of CUS and NCM investment during the period of 2005 to 2009 we can see that bank deposit holds the highest positive correlation coefficient (i.e. 0.9166), shares and debenture investment are also positively correlated at lower rate (i.e. 0.4925). This indicates that the investments of CUS and NCM in Bank deposits are moving in tandem. It reveals that investment in bank deposits are increasing for both the NCM and CUS. As an implication, the growing trends of investment in bank deposit may discourage investment in shares and debentures. Thus, higher return could be foregone accepting a reasonable level of risk.

Policy Implications for Nepal

Lack of awareness among the investors, prevailing too high interest rate in the Nepalese financial market, inadequate level of education of prospective investors, lower level of savings of households and involvement of inadequate number of institution as a mutual fund operator are the major challenges for Mutual funds in Nepal. The existing tax laws should be improved to expand the existing level of operation of mutual fund. The government needs to think of rationalizing the existing

inconsistencies on capital gains tax on individual and institutional investments. The government should allow mutual funds to invest some of their money in the global financial market in order to encourage them to diversify their investment across the global portfolio. Existing mutual fund institutions have to improve quality of service using better technology, more focus on quick dissemination of information. Existing banking and other related industries can utilize their network for mutual fund distribution across the country and expand the scope of operation. The current policy of the Nepal government to allow foreign investment through mutual funds is expected to attract many investors to mutual funds and widen the scope for investment in mutual funds in Nepal.

Conclusion

Mutual funds became mainstream investments around the globe. Mutual funds can provide an opportunity for the risk -averse investors to share their risk and go for high return securities in the capital market. Mutual Funds investors' investment is diversified by spreading the investment across a wide range of stocks, bonds and other securities. The successful management of investment funds requires a proper understanding of the market and investment principles. NIDC Capital Markets provided mutual fund schemes to the public in Nepal, in line with its objective of providing investment opportunities for sound economic development of the country. Larger proportion of investment of NCM fund is invested in shares and debenture, loan and advances holds second preference, followed by bank deposit and government

bonds. Investors in Nepal can take mutual funds as a substitute of fixed deposits in banks rather than as a substitute for investment in securities. In adequate regulatory provision can be considered as a major impediment of development of mutual funds in Nepal. Mutual funds operation can be an integral part of the Nepalese financial system. Provision of separate funds for various investors' segments can be formulated to attract diversified group of investors having divergent needs and preferences. SEBON can prescribe and promote standardized performance measurement procedures for Nepalese Mutual Fund Institutions.

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