Special Section: Profile of Mutual Funds

In an environment where investors and savers lament the lack of investment options, financial savings in the economy do not show an encouraging growth pattern, and a minimum rate of return on savings deposits has been implemented by the central bank to encourage savings, the exponential growth of mutual funds in recent years has served to meet these very needs by mobilizing savings and providing lucrative investment options to both retail and institutional investors.[1] The mutual funds industry, which started out in the 1960s with two state-owned funds, National Investment Trust (NIT) and Investment Corporation of Pakistan (ICP), is now a thriving segment of the financial sector, with an astonishing growth in both numbers and volumes, particularly since FY03. As of end-June FY08, there were 95 mutual funds on offer, with total Net Assets of Rs. 330 billion, in comparison with Rs. 24.8 billion in FY02. These mutual funds are managed by 39 licensed asset management companies,[2] equipped with the requisite professional expertise to manage these funds.

Since equity funds dominate the industry, growth in NAV is directly attributable to the consistently strong performance of equity markets in recent years. Some asset management companies have also introduced other types of funds to cater to a wider variety of investor preferences (**Table 1**). While acknowledging the fact that the size of the industry remains small at 4.4 percent of total financial sector assets, and forms a miniscule proportion of GDP, its significant contribution and growth potential as an important constituent of the financial sector, is irrefutable. Mutual Funds provide direct competition to bank deposits and NSS instruments.

Table 1 : Structure of Mutual Funds
amount in billion Rupees, share in percent

	FY02	FY03	FY04	FY05	FY06	FY07	FY08	Q1-FY09
Net Assets	24.8	51.6	93.7	125.8	159.9	289.11	330.0	273.0
Share by Ownership								
Public Sector	89.6	78.5	52.8	48.5	40.2	31.5	25.7	20.8
Private Sector	10.4	21.5	47.2	51.5	59.8	68.5	74.3	79.2
Share by Type								
Open-end Funds	78.1	78.2	73.6	70.1	72.7	82.4	86.0	87.4
Closed-end Funds	24.9	21.8	26.4	29.9	27.3	17.6	14.0	12.6
Share by Category								
Equity Funds	92.2	81.2	76.5	72.8	63	47.3	40.9	34.4
Income Funds	0	6.6	6.4	6.2	10.6	24.4	23.9	27.6
Money Market Funds	0	4.6	3.6	3.9	7.3	15.0	16.2	17.7
Balanced Funds	6.7	5.8	10.3	9	7.2	4.6	6.5	6.3
Islamic Funds	1.1	1.8	3.2	4.7	5.6	4.9	7.9	8.6
Tracker Funds	-	-	-	-	0.6	0.5	0.8	0.7
Fund of Funds	-	-	-	0.4	0.5	0.3	0.5	0.6
Others	-	-	-	-	-	3.0	3.3	4.1

Source: Annual Audited Accounts of Mutual Funds, except for FY08a and Q1-FY09, where indicative data is from Statistics Department, SBP and MUFAP.

On the supply-side, with a large number of funds on offer, professional asset management companies provide advice to the uninitiated investor to choose the most optimal option in line

[1] This section is based on Annual Audited Accounts of all mutual funds as of end-FY07, due to the lag in the availability of consolidated financial statements for FY08. Indicative data for FY08 and Q1-FY09 has been taken from the Statistics Department, SBP and Mutual Funds Association of Pakistan (MUFAP).

[2] These are either stand-alone NBFCs, or Asset-Management Companies (AMCs) operating as subsidiaries of banks and/or large financial conglomerates.

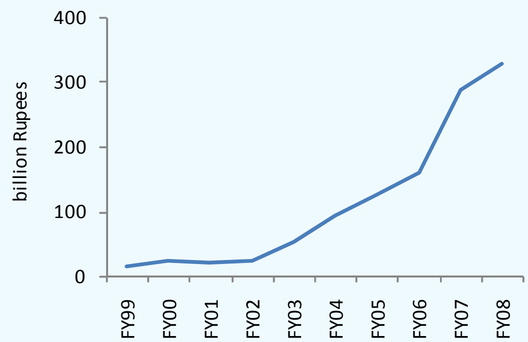
with his risk-return preferences. However, the investor also needs to be able to make his own assessment based on the available information. While there is a large body of information available in the form of regular market reports, it is difficult to find a consolidated comparative analysis of all the mutual funds on offer, their investment portfolios and their risk-adjusted returns.

1.1 Introduction

A mutual fund is a vehicle for pooling together savings of diverse investors – individuals as well as institutions – to collectively invest these savings in stocks, bonds and/or money market instruments. It offers several advantages to investors, particularly retail investors, over taking a direct exposure in capital and money markets. The expertise and resources of the fund manager in identifying and selecting investment options is the most important incentive for investing in mutual funds. Besides professional management, mutual funds offer a diversified investment portfolio that helps to reduce exposure risks for individual investors and allows sharing of transaction costs among all investors.

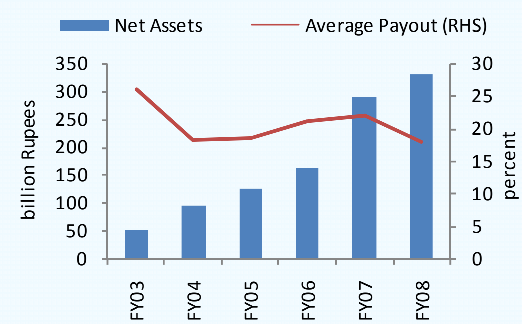
The mutual funds sector has grown rapidly in the last few years (**Figure 1**) and accounted for the largest chunk of 55.3 percent in total assets of the non-bank financial sector in FY08. Between FY02 to FY08, net assets of mutual funds have grown by more than 13 times to reach Rs. 330 billion by the close of FY08. The average payout of the mutual funds industry also grew to 18.0 percent in FY08 (22.1 percent in FY07), as illustrated in **Figure 2**.

Figure 1: Net Assets of Mutual Fund Industry



Source: Annual audited accounts of Mutual Funds

Figure 2: Net Assets and Average Payout of Mutual Funds



Source: Annual Audited Accounts of Mutual Funds

The growth in mutual funds in Pakistan is attributable to: (i) liberalization of the sector; (ii) economic growth and macroeconomic stability that attracted investors, including foreign investors, to the stock market; (iii) increased liquidity with institutional investors, which was channelized into the stock market and mutual funds; (iv) high corporate earnings that increased the earnings potential for mutual funds; and (v) a buoyant stock market that provided mutual funds with good returns in the form of capital gains. Liberalization has helped to facilitate entry of the private sector in the mutual funds industry. Historically, the industry was dominated by public sector funds. However, creation of an enabling legal framework to allow mutual funds to be set up in the private sector and transfer of ICP-managed closed end funds to two private sector investment advisers in FY03 boosted the number and size of funds under the management of the private sector, increased competition and efficiency of the sector and enhanced the quality of fund management. It also provided opportunity to financial institutions, like banks and brokerage firms, to diversify into fund management through subsidiaries and associated companies. As may be seen from **Table 1**, the share of private sector funds in the sector has grown from 10.0 percent to over 79.2 percent over the last six years or so.

The public sector open-end mutual fund, NIT, by its sheer size continues to have a significant share of 31.0 percent in the net assets of the sector.

As of end-June FY07, the mutual funds sector comprised of 66 funds with 47 open-end funds and 19 closed-end funds. The number of funds increased to 95 by end-FY08. Open-end funds dominate the sector, as shown in **Table 1**, due to investors' preference for ease of exit and the flexibility this investment option offers. By end-FY08, the share of open-end funds in the net assets of the mutual funds sector was 86.0 percent as compared to the share of closed-end funds at 14.0 percent. Closed-end mutual funds are more suitable for long-term investors. In the absence of the continuous sale and redemption of certificates by a closed-end fund, investors can only exit the fund at the given market price of the shares/certificates in the stock market, which is generally at a discount to the NAV per share/certificate. However, lack of redemption pressure has its advantages for the closed-end fund, particularly with respect to the ability to invest in illiquid, but high-potential small and medium-sized companies to earn high returns, optimizing investment of assets by maintaining low liquidity and saving on marketing and distribution costs. Given the usefulness of closed-end funds, necessary mechanisms may be introduced to facilitate investors who wish to exit a closed-end fund in order to address their primary concern about ease of exit. Internationally, buy-back of shares/certificates of a closed-end fund by its fund manager, prompted by trading of shares at a certain discount to the NAV, is widely used to minimize the difference between the market price of shares/certificates on the stock market and their net asset value (NAV), so that the secondary market price is not disadvantageous to investors exiting the closed-end fund.

An encouraging development in the mutual funds sector is the increasing diversity of categories of funds offered for public subscription (**Box 1**), as also evident from the variety of entrants in the sector during FY08. By the close of the year, equity funds constituted almost 41.0 percent of the mutual funds sector, income funds constituted 23.9 percent, money market funds had a share of 16.2 percent, balanced funds 6.5 percent, Islamic funds 7.9 percent, while the rest consisted of miscellaneous types of funds such as tracker funds and fund of funds. While, equity funds have the largest share in the mutual funds sector in terms of the number of funds as well as the net assets under management, however, the large assortment of options for investors is a reflection of the ability of fund managers to meet the investment needs and risk profile of a variety of investors.

A significant regulatory development during FY06 was the discontinuation of SECP's requirement for asset management companies to seek foreign collaboration in managing open-end funds.[3] The condition had been imposed at the initial stage of development of the mutual funds industry in Pakistan to facilitate transfer of technical knowledge and expertise from overseas fund management companies to local fund managers. It was considerably successful in enabling local asset management companies to obtain training, know-how and resources from their international affiliates. The condition was removed once SECP was satisfied with the pace of development of the mutual funds sector and the abilities of the asset management companies to manage their respective funds professionally and proficiently. On the positive side, removal of the condition for mandatory foreign affiliation has helped to lower barriers to entry of new fund managers. However, a greater responsibility now lies with SECP in strengthening its licensing criteria for fund managers, monitoring their performance and taking appropriate enforcement actions in order to prevent market abuse. In discharge of this responsibility, SECP – since August 2005 – requires asset managers and investment advisers to obtain from credit rating agencies in Pakistan ratings specific to their fund management quality as well as ratings specific to the

[3] SECP's announcement dated November 2, 2005.

performance of the mutual funds managed by them.[4] The ratings must be disseminated for public information and disclosed in the accounts and advertisements of mutual funds and fund managers. SECP has also started inspections of fund managers, focusing on the quality of their systems and procedures, subsequent to the close of FY06.

Box 1 : Types of Mutual Funds

Each mutual fund has specific investment objectives that mould the fund's assets, investment options and strategy. At the most basic level, there are three types of mutual funds: (i) Equity funds, ii) Fixed-income funds, and iii) Money Market funds. All the other kinds of mutual funds are variations of these three basic types. The characteristics of the various types of funds are detailed below:

Growth Fund : A mutual fund whose focal aim is to achieve capital appreciation primarily by investing in growth stocks. In pursuit of large capital gains, these funds invest in companies with significant earnings or revenue growth, rather than those with high pay-outs. In general, growth funds are more volatile than other types of funds. Direct correlation with market is usually greater than 1.

Asset Allocation Fund : This type of mutual fund invests in a variety of securities in multiple asset classes with the objective of carrying out asset allocation typically by itself. The rationale is to provide investors with suitably diversified holdings and consistent returns. Generally, asset allocation funds are less volatile usually with correlation of almost 1 with the market.

Money Market Funds : A mutual fund which invests in low risk securities, for the most part in government securities, CoDs, commercial paper of companies and other highly liquid and low risk securities. These funds have inherently low risks. Generally, these funds are least volatile with weak correlation with the market.

Tracker Fund*:* This type of fund, as its name suggests, follows the performance of a particular index. Theoretically, these types of funds are as volatile as the market with a correlation of unity.

Fund of Funds*:* A type of mutual fund which invests in other mutual funds, also known as "multi-management" funds. These types of funds enable investors to achieve a broad diversification and an appropriate asset allocation with investments in a variety of fund categories that all are wrapped up into one fund. Due to diversification, these funds are less volatile with moderate correlation with market.

Income Fund*:* A type of mutual fund that emphasizes current income, either on a monthly or quarterly basis, as divergent from targeting capital appreciation. These funds hold a variety of government, municipal and corporate debt obligations, preffered stock, money market instruments and dividend paying stocks. Generally, these funds are least volatile with weak correlation with market.

Balanced Fund*:* Mutual funds that combine investments in shares, short-term and long-term bonds in pursuit of income gains and capital appreciation while avoiding excessive risk. These are also called hybrid funds. The idea behind this concept is to provide investors with a single mutual fund that combines income and growth objectives, by investing in both stocks and bonds. Due to diversification, these funds are less volatile with moderate correlation with market.

Equity Fund : A mutual fund that invests principally in stocks is called equity fund. It is also known as a "stock fund". This type of fund can be further categorized into two categories, i.e. domestic and international, depending on the nature of investments of the fund. Generally, these funds are very volatile with strong correlation with the market.

Sector Fund : A mutual fund that invests entirely or predominantly in a specified (single) sector is a sector specific fund. These funds usually exist in energy, gold, and other precious metals sectors. The risk associated with these funds depends on the specified sector. These types of funds are less diversified. The volatility and correlation with market also depends on the specified sector.

Islamic Funds : A type of fund which entirely invests in Shariah compliant instruments. Islamic funds exist in almost all the forms discussed earlier. Each fund invests in its respective areas of interest keeping in view the rules of shariah compliance. The volatility of each kind of Islamic fund depends on its category and also the relationship with the market in which it operates.

[4] SECP's Circular No. 11 dated 19 August 2005.

During FY07, SBP allowed mutual funds to make overseas investments up to 30.0 percent of the aggregate funds mobilized (including foreign currency funds) subject to a cap of US$ 15 million, whichever is lower.[5] Prior approval of SBP is required by a mutual fund seeking to invest outside Pakistan. In order to manage associated risks, SECP generally requires fund managers to observe certain conditions vis-à-vis international investments. The permission to invest abroad has been welcomed by the mutual funds sector as it would enable them to diversify investments outside Pakistan.

Developments in the regulatory and operating environment indicate a strong potential for the mutual funds sector to continue its growth momentum albeit the challenges faced by the sector need to be addressed expeditiously.

[5] FE Circular No. 11 dated 12 August 2005