DEPARTMENT OF COMMERCE AND FINANCIAL STUDIES BHARATHIDASAN UNIVERSITY, TIRUCHIRAPPALLI – 620024
MBA (FINANCIAL MANAGEMENT)

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SCHEME OF PRESENTATION
UNIT-IV

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INTRODUCTION

Valuation Principles for Mutual Funds

- The valuation of mutual funds is a critical process that ensures transparency and fairness for investors.
- It involves determining the fair market value of the assets held by the fund. Here are the key principles that govern mutual fund valuation

1. Fair Valuation:

- **Realizable Value:** The valuation should reflect the amount that could be reasonably obtained from the sale of the assets.
- **Good Faith:** Valuation should be done honestly and without bias.
- **Appropriate Policies:** The fund should have clear policies and procedures in place for valuation.

2. Consistency:

- **Consistent Methods:** Valuation methods should be applied consistently across different assets and over time.
- **Periodic Review:** Valuation methods should be reviewed periodically to ensure they remain appropriate.

3. Transparency:

- **Disclosure:** The fund should disclose its valuation methodology and any changes to it.
- **Regular Reporting:** Investors should receive regular reports on the fund's net asset value (NAV).

4. Independence:

- **Independent Valuation:** If the fund's assets are complex or difficult to value, it may be necessary to hire an independent valuer.
- **Arm's Length Transactions:** Transactions between the fund and related parties should be at arm's length.

5. Compliance with Regulations:

- **Regulatory Requirements:** The fund must comply with all applicable regulations and guidelines.
- **SEBI Guidelines:** In India, the Securities and Exchange Board of India (SEBI) provides specific guidelines for mutual fund valuation.

SPECIFIC VALUATION METHODS

- **Market Price:** For actively traded securities, the market price is generally used.
- **Fair Value:** For less liquid assets, a fair value estimate may be required, based on factors such as recent transactions, comparable assets, and expert opinions.
- **Cost Method:** In certain cases, the cost method may be used, especially for assets held for long periods.

FAIR VALUATION PRINCIPLES OF MUTUAL FUNDS

Principles of Fair Valuation

Fair Value Reflection: The valuation of investments should reflect their realizable value, considering factors like market conditions, liquidity, and potential risks.

Good Faith and True Manner: The valuation process should be conducted in good faith and with utmost integrity, ensuring that the calculated net asset value (NAV) accurately represents the fund's worth.

Appropriate Valuation Policies and Procedures: Mutual funds must establish and adhere to clear valuation policies and procedures that outline the methodologies used for valuing different types of securities and assets. These procedures should be approved by the Asset Management Company's board.

FAIR VALUATION PRINCIPLES OF MUTUAL FUNDS

Consistent Valuation: The valuation of assets should be consistent over time, using the same methodologies and principles to ensure comparability.

Independent Valuation: For securities that constitute a significant portion of the fund's assets, independent valuers may be appointed to provide an objective assessment.

Disclosure: Mutual funds must disclose their valuation policies and procedures to investors, ensuring transparency and accountability.

Valuation Methods Used by Mutual Funds:

Market Value: For securities with readily available market quotations, the market price is generally used as the valuation basis.

Fair Value: For securities without readily available market quotations, the fund's board or trustees determine a fair value based on factors like recent transactions, comparable securities, and expected future cash flows.

Cost Method: In certain cases, such as for unlisted securities or illiquid assets, the cost method may be used as a valuation basis.

IMPORTANCE OF FAIR VALUATION

- **Investor Protection:** Fair valuation ensures that investors receive accurate information about their investments, enabling them to make informed decisions.
- **Market Integrity:** Accurate valuation practices contribute to the overall integrity and efficiency of the mutual fund market.
- **Regulatory Compliance:** Adherence to fair valuation principles helps mutual funds comply with regulatory requirements and avoid penalties.

NET ASSET VALUE

NAV stands for Net Asset Value. The performance of a mutual fund scheme is denoted by its NAV per unit. NAV per unit is the market value of securities of a scheme divided by the total number of units of the scheme on a given date.

THE ROLE OF NAV IN FUND PERFORMANCE

1. Indicator of Growth:

Upward Trend: A rising NAV generally indicates that the fund's investments are appreciating in value, leading to higher returns for investors.

Downward Trend: A declining NAV suggests that the fund's investments are losing value, potentially resulting in losses for investors.

2. Basis for Purchase and Redemption:

Buying Units: Investors purchase units of a mutual fund based on the NAV. A higher NAV means each unit represents a larger share of the fund's assets.

Selling Units: When investors redeem their units, they receive the current NAV per unit.

THE ROLE OF NAV IN FUND PERFORMANCE

3. Comparison with Benchmarks:

Relative Performance: NAV can be compared to the NAV of benchmark indices (like the S&P 500 or Nifty 50) to gauge how well a fund is performing relative to the broader market.

4. Calculation of Returns:

Absolute Returns: The percentage change in NAV over a specific period reflects the fund's absolute returns.

Risk-Adjusted Returns: Factors like standard deviation and Sharpe ratio, which consider risk along with returns, can be calculated using NAV data.

5. Fund Manager Evaluation:

Performance Assessment: A fund manager's ability to generate consistent NAV growth is often used to evaluate their performance.

DIVIDENDS AND DISTRIBUTABLE RESERVES: A BREAKDOWN

- Dividends and distributable reserves are two key financial terms that are closely related, particularly in the context of a company's shareholder returns.

Dividends

- Definition: Dividends are payments made by a company to its shareholders, typically out of its profits. These payments are a way to distribute a portion of the company's earnings to its owners.

Types of Dividends:

Cash dividends: The most common type, where the company pays a specific amount of money to each shareholder.

Stock dividends: Instead of cash, the company distributes additional shares of its stock to existing shareholders.

Property dividends: The company distributes assets other than cash or stock, such as products or services.

Dividend Policy:

The decision of how much to pay in dividends is influenced by various factors, including the company's financial health, growth prospects, and the expectations of its shareholders

DISTRIBUTABLE RESERVES

- Definition: Distributable reserves are the portion of a company's retained earnings that can be legally distributed to shareholders as dividends. These reserves are typically accumulated from past profits that have not been used for reinvestment or other purposes.

- Conditions for Distribution: Before a company can distribute dividends, it must ensure that it has sufficient distributable reserves and that the distribution does not violate any legal or contractual obligations.

- Importance: Distributable reserves provide a cushion for a company to meet dividend payments and other obligations. They also indicate the company's financial strength and its ability to reward shareholders.

RELATIONSHIP BETWEEN DIVIDENDS AND DISTRIBUTABLE RESERVES

1. **Source of Dividends:** Distributable reserves are the primary source of funds for dividend payments. A company cannot distribute dividends in excess of its distributable reserves.

2. **Dividend Policy:** The level of distributable reserves can influence a company's dividend policy. A company with ample distributable reserves may be more likely to pay higher dividends or more frequent dividends.

ENTRY AND EXIT LOADS IN MUTUAL FUNDS

Entry and exit loads are fees charged by mutual fund companies when you invest in or withdraw from a mutual fund scheme.

Entry Load

1. **What is it?** A fee is charged when you purchase units of a mutual fund.
2. **Purpose:** Typically used to cover the costs of distribution and marketing.
3. **Current Status:** In India, entry loads were abolished in 2009.

Exit Load

- **What is it?** A fee is charged when you sell or redeem your units of a mutual fund.
- **Purpose:** To discourage short-term investing and to provide stability to the fund.
- **Variation:** Exit loads can vary depending on the fund and the holding period. Some funds may have no exit load, while others might charge a percentage of the redemption amount.

Accounting and Reporting Requirements in Mutual Funds

Mutual funds, as collective investment schemes, are subject to specific accounting and reporting requirements to ensure transparency and investor protection. These requirements typically vary depending on the jurisdiction and regulatory framework, but generally include the following:

Financial Statements

- **Annual Financial Statements:** Mutual funds are required to prepare annual financial statements, including a balance sheet, income statement, cash flow statement, and notes to the financial statements. These statements should provide a comprehensive overview of the fund's financial position, performance, and cash flows.

Valuation of Investments: The valuation of investments held by the mutual fund is a critical aspect of financial reporting. Generally, investments are valued at fair market value, which may require professional valuations for certain asset classes.

Expense Reporting: Mutual funds must disclose all expenses incurred, including management fees, operating expenses, and transaction costs. These expenses are typically deducted from the fund's net asset value (NAV).

Performance Reporting: Mutual funds are required to provide periodic performance reports, including returns, risk measures, and comparisons to relevant benchmarks.

RELATIONSHIP BETWEEN DIVIDENDS AND DISTRIBUTABLE RESERVES

Regulatory Compliance

1. Regulatory Framework: Mutual funds must adhere to the specific regulatory framework of the jurisdiction in which they operate. This includes compliance with securities laws, accounting standards, and other relevant regulations.

2. Investor Disclosure: Mutual funds must provide investors with comprehensive information about the fund, including its investment objectives, risks, and fees. This information is typically contained in the fund's prospectus.

3. Audit Requirements: Mutual funds are generally required to undergo independent audits to ensure the accuracy and completeness of their financial statements.

RELATIONSHIP BETWEEN DIVIDENDS AND DISTRIBUTABLE RESERVES

Other Requirements

1. **Tax Reporting:** Mutual funds may be subject to various tax requirements, including income tax, capital gains tax, and sales tax.
2. **Investor Reporting:** Mutual funds may be required to provide investors with periodic statements, including account balances, transaction history, and tax information.
3. **Internal Controls:** Mutual funds must have adequate internal controls in place to safeguard assets, prevent fraud, and ensure compliance with regulatory requirements

Specific regulatory bodies such as the Securities and Exchange Commission (SEC) in the United States, the Securities and Exchange Board of India (SEBI) in India, and the Financial Conduct Authority (FCA) in the United Kingdom have detailed guidelines and regulations governing the accounting and reporting requirements of mutual funds.

TOTAL EXPENSE RATIO (TER) AND PRICING OF UNITS IN MUTUAL FUNDS

1. **Total Expense Ratio (TER)** is a crucial metric in mutual funds that indicates the annual cost of managing a fund. It's expressed as a percentage of the fund's average net assets. A higher TER means more of your investment goes towards covering the fund's operational expenses.

2. **Pricing of Units** in a mutual fund is directly influenced by the fund's performance and TER. The unit price is calculated by dividing the total net assets of the fund by the total number of units outstanding.

FACTORS AFFECTING TER AND UNIT PRICE

1. **Fund Size:** Generally, larger funds have lower TERs due to economies of scale.
2. **Investment Style**: Actively managed funds tend to have higher TERs compared to passively managed (index) funds.
3. **Fund Structure:** Open-ended funds typically have lower TERs than closed-ended funds.
4. **Fund Performance:** A fund's performance can indirectly impact the unit price. If a fund consistently outperforms its benchmark, it may attract more investors, leading to increased assets and potentially lower TERs.

HOW TER AND UNIT PRICE IMPACT INVESTORS

1. **Returns:** A higher TER reduces the potential returns of a fund, as more of your investment is used to cover expenses.

2. **Unit Price:** While the unit price can fluctuate based on market conditions, a higher TER can negatively impact its long-term growth.

3. **Investment Decision:** Investors should carefully consider the TER of a fund before investing. A lower TER can lead to higher potential returns over time.

Tax Applicability in Mutual Funds

- The tax implications of mutual fund investments vary depending on the type of fund and the holding period. Here's a breakdown:

Equity Funds

- **Short-Term Capital Gains (STCG):** If you sell equity fund units within one year of purchase, you'll be subject to a flat 15% STCG tax.
- **Long-Term Capital Gains (LTCG):** If you hold equity fund units for more than one year, you'll enjoy a tax-free exemption of up to ₹1.25 lakh per year. Gains exceeding this limit are taxed at 12.5%.

Debt Funds

- **Short-Term Capital Gains (STCG):** Gains from debt funds held for less than three years are taxed as per your income tax slab.

- **Long-Term Capital Gains (LTCG):** Gains from debt funds held for more than three years are taxed at 20% with indexation benefits. This means you can adjust the cost of acquisition to account for inflation, reducing your taxable gains.

Dividend Income

- **Dividend Distribution Tax (DDT):** Previously, mutual funds used to pay DDT, which was a tax on dividends paid to investors. However, this has been abolished.
- **Tax on Dividend Income:** Now, dividend income is taxable in the hands of the investor according to their income tax slab.

Tax Deducted at Source (TDS)

- **Dividend Income:** If you receive dividend income from mutual funds exceeding ₹5,000 in a financial year, the AMC will deduct TDS at 10%.
- **Capital Gains:** TDS is not applicable on capital gains from mutual funds.

Securities Transaction Tax (STT)

- **Equity Funds:** STT is applicable on the sale and repurchase of units in equity-oriented mutual funds. The rate depends on the transaction value

GST on Mutual Funds: A Brief Overview

- **Goods and Services Tax (GST)**, a comprehensive indirect tax in India, has had a significant impact on various sectors, including the financial services industry. Mutual funds, as a popular investment vehicle, have also been affected by the implementation of GST.

Implications of GST on Mutual Funds:

Increased Expense Ratios:

- Service Tax Increase: The introduction of GST led to an increase in service tax rates from 15% to 18%. This hike directly affected the expense ratios of mutual fund schemes.
- Additional Charges: GST is also applicable on certain additional charges levied by mutual fund houses, such as transaction charges or exit loads.

Impact on Distributors:

- Registration and Tax Liability: Mutual fund distributors with an annual turnover exceeding ₹20 lakhs are required to register for GST and pay taxes on their commissions.
- Exemption for Small Distributors: Distributors earning less than ₹20 lakhs annually are exempt from GST registration but may still need to collect and remit taxes on behalf of the mutual fund house.

Security Transaction Tax:

- New Tax: Prior to GST, security transactions were not subject to service tax or VAT. However, under GST, these transactions became taxable, increasing the overall cost of trading in securities.

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