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Fund Allocation

KEYWORDS: Debt fund, equity fund, fund allocation, Scheduled Commercial Bank

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ABSTRACT *Investors have two options to invest either in equity or in debt fund. The Indian financial institutions chose debt fund. More than two-third of total collected funds by Scheduled Commercial Banks has been allocated to debt fund. It raises their net profit.*

Introduction

Investors have two options-Demat account or mutual funds- to choose. In the former case investors directly enter the financial market by opening Demat account in which securities are bought or sold with the help of brokers. In the later case capitals of the investors are pooled through selling retail investment products and funds are professionally managed by fund manager. This capital in mutual fund is either invested in equity fund or debt fund. It infers that an investor has three options – opening Demat account, Choosing equity fund or opting debt fund.

Literature Review

Mutual fund is the combination of equity, debt and hybrid fund. Equity mutual fund is risk adjusted return in which individual fund does not earn higher returns from following the momentum strategy in stock (Carhart, 1997) because of investment constraints (Almazan, 2004). Restriction on competing products is the reason of the development of money market and short term bond funds (Klapper, 2000). Therefore, an investor should invest in small equity fund whose trading activity is high (Dahlquist, 2000) or whose expense ratio is low (Malkiel, 1995) . Funds that heavily underperform have very high expense ratio, while funds that are successful do not increase revenues by raising their fees but benefit from increased size of their funds (Elton 1996, Carhat 1997). Actively managed equity funds charge higher fees than index tracking funds or bond and money market funds, reflecting the higher costs of employing investment management staff to achieve diversification and strategy (James et al. 1999). Funds charge lower fees when they have smaller boards and a large proportion of independent directors (Tufano and Sevick, 1997). Larger and more mature funds as well as no load funds have lower expense ratio (Malhotra and Mcleod, 1997). Aggressive growth funds charge higher entry and exit fees to discourage redemption because they hold more of the smaller, less liquid stocks (Chordia, 1996). However, despite the basic academic advice offered to investors to prefer low expense index funds, actively managed funds continue to be popular (Gruber, 1996). To decrease the risk it is advised to use derivative. Bond mutual fund uses derivatives more than equity mutual funds. Use of derivative is negatively correlated with fund age and positively correlated with fund size (Johnson and Yu 2004) and it is positively correlated with asset turnover (Koski and Pontiff, 1999). Derivatives are used for trading rather than hedging (Minton et al. 2009).

Objective

To know how to allocate fund to minimize risk.

Methodology

Risk (β), expense ratio and NAV (Net Asset Value) has been used in the present study to allocate the fund. A case study of Scheduled Commercial Banks (SCB) has been undertaken for the study to know the pragmatic knowledge about the allocation of fund.

Analysis

Table-1 gives better ideas about allocation of funds. It shows that risk taker rich investors should invest in equity fund and risk averter poor investors should invest in debt fund (G-Sec, Certificate of Deposit and so on). The SCB takes low risk. The Scheduled Commercial Banks (SCB) of India invests more than 80.00 per cent in debt market, as shown as in table-2. Most of the SCB funds were invested in Central Government Securitas (G-Sec). SCB invested two-third of its total funds in G-Sec. Less than 10.00 per cent of its fund was invested in equity funds. Perhaps this is the reason why net profit of SCB increased Rs. 24582 Cr. in 2006 to Rs. 57100 Cr. in 2010. As shown as in table-3.

Table-1: A comparative study of gain between Equity Fund and Debt Fund

Issues	Mutual Fund	
	Equity Fund	Debt Fund
Volatility	Highly volatile	Less volatile
Gain depends on	Market growth	Government declaration
Possibility of no gain	yes	No
Possibility of Loss	Yes	No
Possibility of very high gain	yes	Lower than equity fund
Suitable for	Rich investors	Middle
Who should invest	flexible income investor	Fixed income investor

Table-2: Investment by Scheduled Commercial Banks (Rs. Cr)

Allocation of funds	2008		2009	
	Aggregate	Per cent	Aggregate	Per cent
Central Govt. Securities	772565	66.50	920579	64.54
State Govt. Securities	151811	13.06	229030	16.05
Other Trustee Securities	11557	1.00	9897	0.70
Share and Debenture of Joint Stock Companies	91498	7.88	89846	6.31
Other investment	134391	11.56	176893	12.40
Total	1161822	100	1426245	100

Source: Statistical Tables Relating to Banks, RBI

Table-3: Sources of Earnings to SCB (Rs. Cr.)

Items	2006	2007	2008	2009	2010
Interest earned	185388	231675	308482	388482	415752
Other income	35368	43041	60391	75220	78519
Interest expended	107161	142420	208001	263223	272084
Operating expenses	59201	66319	77283	89581	99769
Provisions and contingencies	29812	34775	40864	58147	65310
Total earnings	220756	274716	368873	463702	494271
Total expenses	166362	208739	285284	352805	371852
Provisions and expenses	29812	34775	40864	58147	65310
Net profit	24582	31203	42726	52750	57109

Source: Statistical Tables Relating to Banks, RBI

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Conclusion

Investors have two options to invest either in equity or in debt fund. The Indian financial institutions chose debt fund. More than two-third of total collected funds by Scheduled Commercial Banks has been allocated to debt fund. It raises their net profit.

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