The two-headed Goliath—Mutual Funds and their distributors

Exorbitant annual fees and commissions to distributors are hurting Indian mutual fund investors. There is a solution, but don't expect your local distributor to tell you about it

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Every year, Rs 15,000 crore is automatically deducted from investors' mutual fund investments and paid to mutual fund salespeople

High fees and commissions, along with the mis-selling that they cause, leave investors significantly poorer

The solution is zero-commission plans. Yet only 5% of individual investors are doing this

What's keeping zero-commission plans from being mainstreamed and why?

Summary

Close

Indian mutual funds and distributors have sold investors a story: That investors can get rich without taking much risk; mutual fund managers can beat the market; distributors are selling them the best products; distributors know how to pick the best mutual fund schemes; fees/commissions don't matter and they are anyway very low; and the only way to invest is through distributors.

The reality is exactly the opposite: Investors have been pushed to take too much risk because equity funds have the highest fees/commissions; Indian mutual funds, as a whole, do not beat the index; distributors use ambiguity in the regulations to push schemes with the highest fees/commissions and mutual funds like this arrangement; no one can predict which mutual fund schemes will have the best performance even over a 10 year period. In addition, Indian MF fees and commissions are some of the highest in the world.

There is a better way. Zero-commission plans. Index funds. But the current MF ecosystem—large asset management companies and a network of distributors—would rather you know as little about them as possible. Read the story to know more.

The 2017 book, '*How Fund Managers are making you Rich*', resonates with the advertisement jingle 'mutual funds *sahi hai*' (mutual funds are terrific). But the book also talks about a meeting between Ajit Dayal, the founder of Quantum Mutual Fund, and senior management at other mutual funds (MFs): "Dayal…called the mutual fund industry a den of thieves". It is impossible to reconcile the title of the book with that quote.

There are others who are critical of MFs. Sanjiv Shah, former CEO of Goldman Sachs' Indian MF and co-founder of Benchmark AMC, has written in an article that: "If one looks at the way [mutual fund asset management company] AMC business is structured, you wouldn't be wrong to surmise that intermediaries [and not the end investors] are the clients".

These statements are in strong contrast to the fact that, in general, mutual funds are infinitely better products than insurance investment products. By a rough estimate, 2% of MF products—across MF houses—are amongst the best investment products in

India. Ironically, it is because of this that it is worth discussing the flaws in MFs and how one can find the needle in the haystack.

To understand the flaws in the system, ones that ultimately cost individual investors a significant share of their overall investment, let's delve into a general MF investment scenario.

Ms X signs up with an MF distributor. These distributors are, for all intents and purposes, salespeople. Through the distributor, Ms X invests Rs 1 crore ($142,857) in an MF scheme. The MF scheme is a pool of money that belongs to Ms X and other investors like her, and the money is managed by an asset management company (AMC) such as Reliance AMC or Aditya Birla Sun Life AMC.

Every year, the AMC deducts about 2%—around Rs 2 lakh ($2,857)—from Ms X's investment in the scheme. From this amount, it pays around Rs 90,000 (US$ 1,286) to the distributor as an annual commission. The remaining Rs 1.1 lakh ($1,571) goes towards the AMC's expenses (including advertising and salaries) as well as its profits. After this deduction, it invests the remaining amount across various equity shares.

This system works well for distributors and AMCs. As per estimates and conversations with industry experts, MF distributors automatically take an estimated Rs 15,000 crore ($2.14 billion) from individual/institutional investors' MF investments each year. Large AMCs are similarly well taken care of. Anecdotally, India's largest mutual fund HDFC AMC's annual profit was Rs 722 crore ($103 million), with its five-year average Return on Equity of 42% per annum more than triple that of the average for the 50 largest listed companies in India.