

Impact of Mutual Fund Classification on Investors, Funds and Stock Market

“It is desirable that different schemes launched by a Mutual Fund are clearly distinct in terms of asset allocation, investment strategy etc. Further, there is a need to bring in uniformity in the characteristics of similar type of schemes launched by different Mutual Funds. This would ensure that an investor of Mutual Funds is able to evaluate the different options available, before taking an informed decision to invest in a scheme.”

-SEBI (Circular - SEBI/HO/IMD/DF3/CIR/P/2017/114)

On 6th October 2017, Securities Exchange Board of India (SEBI) issued a circular classifying mutual funds into specific categories. For example, the new regulation required Large cap funds to invest at least 80 percent of their total assets in equity and equity related instruments of top 100 companies in terms of full market capitalization. This classification of funds was meant to simplify mutual fund products, improve comparability and help customers make better decisions. In this essay, we study the impact of this regulation on fund performance, investor's fund flow-performance sensitivity and stock returns.

First, we find the investor fund flow sensitivity to performance has increased, indicating that investors are better able to compare funds post the new regulation. Second, this has resulted in an increase in competitive intensity among the funds. Accordingly, we find the performance of funds has increased. However, funds earlier with broad investment mandate would have to now follow narrow investment mandate which has negatively impacted their performance. Third, we find that the new regulation has negatively impacted market quality. The new regulation mandates AMFI (Association of Mutual Funds in India) to update the acceptable investment universe for market cap based mutual funds every six months. We find that this induces mutual funds into predictable patterns of buying and selling increasing return predictability of stocks.

We conclude that while the new regulation has had the desired effect of improving comparability across funds and increasing fund performance due to higher competition, it has resulted in predictable patterns of buying and selling stocks negatively impacting market quality.