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EXPERT SPEAK

Variable Entry Load: Boon or Bane

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Variable Entry Load: Boon or Bane



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Recent announcement by Securities and Exchange Board of India (SEBI) that the investor would have a say on the load structure and the commission that eventually gets passed on to the investor, sparked a row amongst distributors / agents alike. With so much information being bombarded on net, investors are eternally confused if the advice they got from their financial counselor benefited them or the counselor himself.

Current Trend

Mutual funds are mainly sold to investors through distributors / agents / brokers - they necessarily perform 2 basic functions - act as agents of the asset management companies (AMCs) in helping them sell their schemes and also as advisors to investors.

Distributors are compensated for their services in 2 ways - A fixed charge is deducted from the investor's subscription by the AMC (known as entry load) and is paid to the distributors. In equity schemes this is generally around 2.25% of the subscription. In addition, the AMC is free to pay the distributors amounts as trail or additional amount depending on assets under management (AUM). While the entry load is mainly passed on to the distributor, the expense ratio is mainly kept by the AMC with only a small portion being passed on as trail.

The entry load phenomenon has led to a lot of criticism, from investors and SEBI alike. SEBI mandated a zero entry load, in cases where investors apply directly for the schemes of mutual funds with effect from Jan. 4, 2008. This had a luke-warm response with about

4%-5% mutual fund applications being made in this mode. However, other investors seeking a distributor`s assistance have no control over the commission paid to the distributor.

The proposal

Various stakeholders are of the view that the commission paid to the distributors should be determined by the investor in consultation with the distributor depending on the service provided by the distributor i.e., to have a variable entry load structure. This is a commonly prevalent practice globally. This was initiated from the fact that the entry load was charged on the value of investment made and had nothing to do with the service provided by the distributor. SEBI is of the view that variable load structure would bring in greater transparency with regard to the commission paid to the distributor/agent/broker.

Some of the highlights of this arrangement include -

- > Load chargeable has to be agreed by both - advisor and investor and signed upon
- > Load mentioned would have to be within the prescribed limit of 6% for a scheme

The following options have been adjudged to operationalise the issue of implementing variable entry loads:

- > Separate section in the application form: Within the application form itself, there could be a section where the investor could indicate the commission payable to the distributor which would be signed off jointly by the investor and the distributor. The AMC would then deduct the amount payable and pay the distributor.
- > Separate cheque issued by the investor towards commission: In this mode the investor issues two cheques - one for his investment in the name of the scheme and the second one in the favor of distributor towards the commission agreed to be paid.

The `Pros` in the proposal

- > Investors have the flexibility to negotiate on their own on the quantum of money they want to pay for buying a unit of mutual fund
- > Prudent investors will have the opportunity to claim better value-add from the distributor or lower the entry load on their investments
- > Greater transparency on the expense mandate of the Mutual Fund
- > Distributors are prodded to provide superior service to avail higher levels of commission
- > Moving towards international standards of investments by encouraging investors to participate in the overall investing strategies
- > It is indeed a commendable step towards fee discovery mechanism ? however, Indian investors are required to move into a mindset that there aren`t any free lunches even in the investment world

The `Cons` in the proposal

- > Market is anyway under severe pressure and all constituents - business has taken a serious dip - introducing variable entry loads at this juncture, in the manner proposed, can be potentially disruptive and confusing and will bring in additional challenge
- > There could be substantial increase in unscrupulous distributors - especially amongst the retail / small investors ? there is a fear that distributors could start charging a higher percentage than the current entry loads. The fact is that most investors do not fill the forms themselves and this could actually be misused.
- > Nowhere in the proposal, there is any mention of what the default % would be ? if the investor has not chosen any of the option, then whether it would be an application which would undergo rejection still remains unanswered
- > Experts are of the view that a majority of customers in India are not mature enough to

negotiate with agents/brokers/distributors on their own. In fact, variable entry loads could actually benefit larger investors more because of their bargaining power. Distributors are likely to charge higher loads from smaller investors.

> Operational complications could figure out (especially in the second option, where 2 cheques are to be issued) - it could lead to cumbersome investment process. It would operationally be almost impossible to handle Systematic Investments by this option.

Good advice comes at a cost - an individual seeks the help of an advisor with Rs 10k p.m investible surplus and the same is prudently invested across 4 diversified equity funds. This could be a welcome step over the longer term. One must note that the distributor model is among the cheapest. Direct sales models could actually be eventually costlier to the investor.

There are more than one ways to misuse the current proposal, there isn't much discrepancy which is seen around especially in the debt fund segment - within the rural strata, there could be agents/distributors duping investors to cough up a substantial entry load (commission payout) on debt funds for which there are currently no or very low entry loads; many a times, investors do not take adequate care or simply leave it to the distributor to fill out application forms, such gaps could prove to be an opportunity for enhancement of payouts for the unethical distributors.

This move is great, and a step towards attaining international standards. The biggest positive is that it will push the distributors towards providing better advice and service. The timing is inappropriate from the perspective of current market trends and investor sentiments. The Mutual Fund industry also fears that such a move will encourage distributors to sell high commission yielding investment instruments, which could hit the MF business further (especially in the long term) and may actually achieve the opposite of the stated objective. The small investor could be hit badly as distributors could increase rather than reduce loads.

Every proposal would have two distinct view - some beneficial and some not so beneficial. It is for the key stakeholders come up with a proposal which would be in the best interest of the investor. At the same time, the regulator should shoulder the responsibility of ensuring that unethical practices are under stringent check. A phased approach actually maybe the best way out!!

Anil Rego is the founder and CEO of Right Horizons, an Investment Advisory and Wealth Management Company. Right Horizons has successfully practiced a de-risked model with a Contrarian approach.