Debt funds get another layer of safety, equity options increase

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- **Sebi gives regulatory cover to investors, but they still need to evaluate their portfolios before investing.**
- **Look at portfolios and strategies of schemes, and their suitability to your risk preferences and investing period.**

The Securities and Exchange Board of India (Sebi) brought in two new regulations recently that aim to enhance the investment experience in mutual funds. One brought in an additional layer of protection for investors in fixed-income products and another gave equity investors an additional category to invest in, as per their risk and return preference.

We explore the impact on retail investors in detail.

Cushion for liquidity risk in debt funds

Sebi has recognized liquidity risk as an important aspect of investing in fixed-income securities.

While Sebi's fund categorization exercise gave investors visibility on the credit and interest rate risks in debt fund categories, liquidity risk couldn't be assessed easily. A downgrade in a paper, market conditions and other factors may lead to situations of tightening liquidity where a fund could find itself unable to meet redemption requests. As a preventive measure, Sebi has mandated all open-ended debt funds to hold not less than 10% of their net assets in liquid instruments such as cash, treasury bills and government securities (G-secs).

"The move creates three layers of protection from liquidity risks—cash buffer, liquid assets like G-secs and AAA-rated securities that a fund holds and the available borrowing limits," said Arvind Chari, head, fixed income and alternatives, Quantum Advisors Pvt. Ltd.

This may give investors a sense of comfort on the ability of a fund to honour their redemptions, but its efficacy may depend upon the category of funds and the situation. "If the fund holds a lower-rated portfolio and there is a run on the scheme, then the 10% cushion of liquid assets may not really be of much use," said Joydeep Sen, corporate trainer in debt markets and author, referring to poor liquidity in the bond markets in the sub-AA category. A quick look at the portfolio of some debt fund categories shows that many of them already hold a combination of cash and G-secs around this prescribed limit. However, this is likely to change when the risk perception changes and debt funds are more willing to take on credit risk.

Sebi's cash holding rule will ensure that investors have a layer of liquid asset protection but it won't affect the returns much. "The impact on the returns will be nominal. It mandates only 10%. Funds anyway maintain some component in cash equivalents (TREPS) and liquid assets," said Sen.

In another move intended to keep the focus on risk management in debt funds, Sebi has extended the requirement to undertake periodic stress tests to all open-ended debt funds. This was initially mandated only for the liquid fund category. The purpose of the stress test is to determine the vulnerability of a scheme and its net asset value to interest rate risk, credit risk and liquidity and redemption risk. More choice for equity fund investors

Sebi's guidelines in September required the popular multi-cap category to take at least 25% exposure each to large-, mid- and small-cap segments of the market.

Investors who chose these schemes for their strategy of positioning the portfolio to the segment that was likely to do well found themselves with funds that may take greater exposure to riskier segments. The introduction of the flexi cap category has given such investors a way out since it allows fund houses to retain the flexible allocation strategy of erstwhile multi-cap schemes. These schemes gave the advantage of professional call on segments expected to do well and managed risk by moving to the stable large-cap segment in periods of uncertainty.

"The stress test may help create checks and balances in fund management, if implemented in the right spirit," said Chari, while cautioning against it becoming a theoretical exercise.

"The rigidity in the allocations of the multi-cap category is something that investors should carefully consider. The flexicap approach gives greater flexibility to adapt to market dynamics," said Dilshad Billimoria, director, Dilzer Consultants Pvt. Ltd, a Sebi-registered investment adviser.

Fund managers will see greater scrutiny as investors will look for demonstration of the benefits of a flexible allocation now that they have a fixed allocation strategy as an option to consider. Billimoria suggested that investors should wait for clarity from fund managers on their strategies for the two categories.

Investors looking for a healthy exposure to growth-oriented mid- and small-cap segments, with adequate time horizon to ride out higher volatility, will find the multi-cap category attractive. They will be able to invest in different market segments in equal proportion through a single fund rather than having to track and invest in separate large-, mid- and small-cap funds.

A multi-cap will also be more efficient in rebalancing exposures if one segment overshoots. If the investors were to execute the rebalancing strategy themselves by holding large-, mid- and small-cap funds, they would have to contend with not only tax implications, unlike in multi-cap funds, but also with behavioural blocks to booking profits in a segment doing well. Not rebalancing periodically will increase the risk in the portfolio.

Sebi's new guidelines seek to give regulatory cover to investors. However, they should go one step ahead and look at the portfolios and strategies of schemes, whether debt or equity, and evaluate them for their suitability to their own risk preferences and investment period.

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