Mirae Asset Knowledge Academy
Profit from Knowledge

Liquid Funds

A recipe for safety, liquidity & returns

What do you seek in every investment - safety, liquidity and returns? If you thought opening savings deposits with banks is the only way to park funds and enjoy such benefits, liquid funds are equally feasible. When it comes to parking idle cash, investors tend to look more for safety and liquidity than returns - which drives them to park reserves in savings accounts and earn a return of 4-6%. Now, if liquid funds offer higher returns (over 7%[1]), and promise safety and liquidity, why not consider them?

1 Returns - More remunerative then saving bank acount

Even after the Reserve Bank of India (RBI) deregulated interest rates since October 2011, most banks still offer around 4% on savings deposits. Few offer higher rates, but insist on a higher minimum deposit, which small retail investors may not find viable.

Comparatively, liquid funds may offer a higher return, but may involve a slightly higher risk with respect to liquidity and safety. Liquid funds, represented by the CRISIL - AMFI Liquid Fund Performance Index, have returned 8.18% in the last one year ended March 31, 2016 (Table 1).

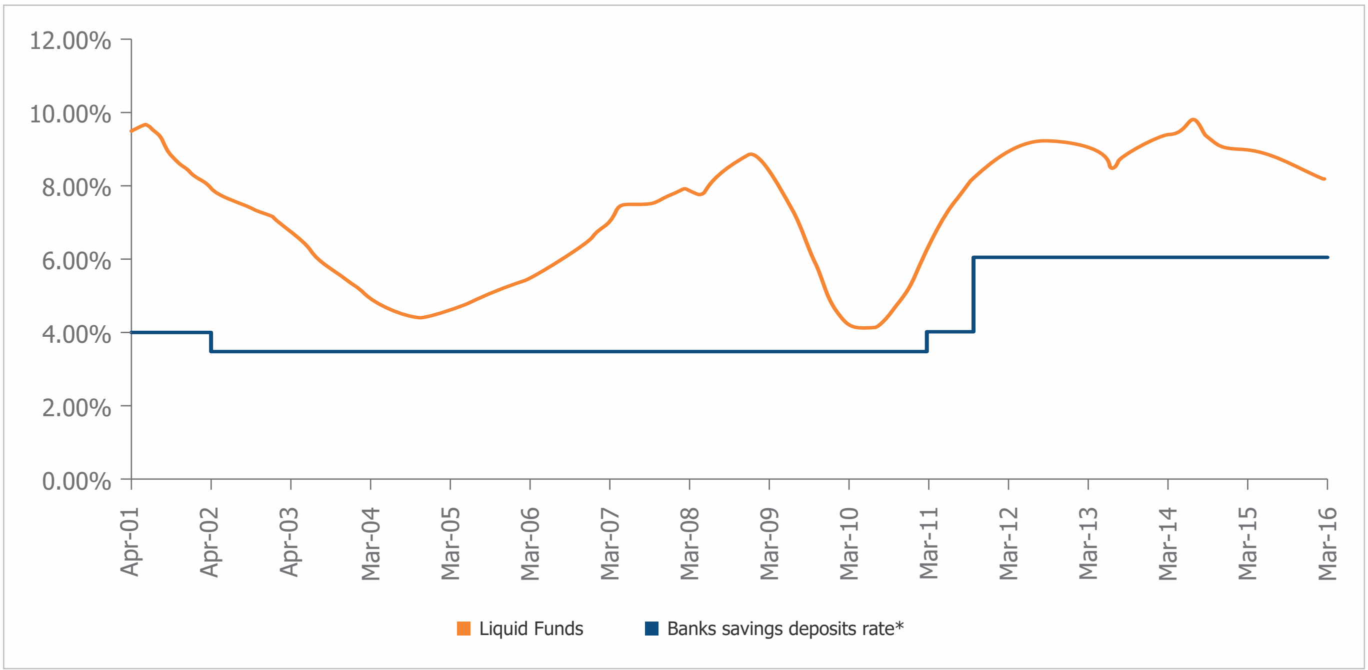
Table 1: Performance

	3 Months	6 Months	1 Year	3 Years	5 Years
Liquid fund category*	8.04	7.85	8.18	8.82	8.86
Crisil Liquid Fund Index (Benchmark)	7.96	7.67	8.04	8.82	8.63

*Represented by CRISIL - AMFI Liquid Fund Performance Index. Annualised returns as of March 31, 2016

Another analysis shows liquid funds have outperformed banks' saving deposits throughout since 2000 (Chart 1).

Chart 1: One-year rolling returns of liquid funds versus savings deposit



*Banks offers interest as high as 6% post the deregulation of savings deposit rate since October 25, 2011.
Liquid funds represented by CRISIL-AMFI Liquid Fund Performance Index.

2 Liquidity

Liquid funds primarily invest in money market instruments such as certificates of deposits (CDs) and commercial papers (CPs), and government treasury bills maturing within 91 days. While 91 days may appear on the higher side, liquid funds[2] on an average have a portfolio with average maturity of less than 40 days. Such a portfolio helps funds provide high liquidity to investors. Accordingly, redemption requests are processed within 24 hours. The cut-off time on withdrawal from a liquid fund is generally 2 p.m. on business days. Hence if an investor places a redemption request by 2 p.m. on a business day, the funds will be credited to his/her bank account on the next business day by 10 a.m. Most liquid funds have no entry and exit loads, thus further easing the load on the investor.

1. Average 1 year daily rolling returns of CRISIL-AMFI Liquid Fund Index since its inception in April 2000.
2. Average maturity of CRISIL ranked liquid funds (as of December 2015) for the past one year ended February 2016.

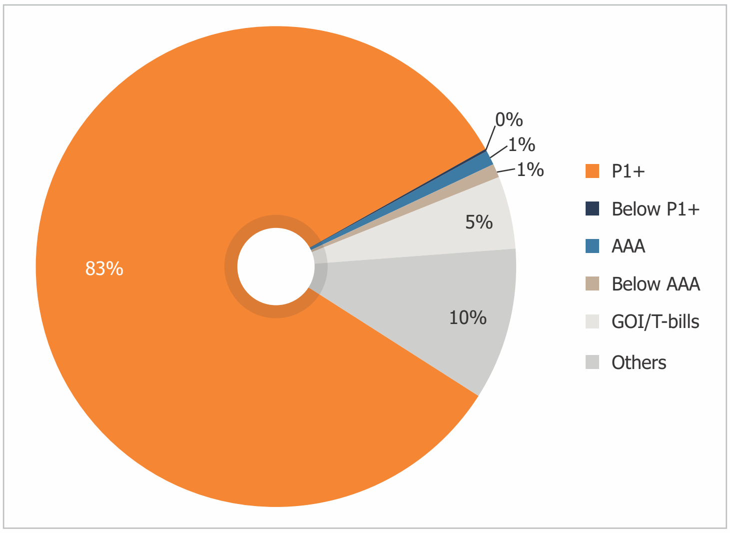
3 Safety - The right pick amidst risks

Choosing the right liquid fund from a universe of 50 schemes[3] is important because the underlying risk may vary across funds depending on their portfolio attributes. Though liquid funds offer higher returns than savings deposits, they are exposed to credit and liquidity risks. Investors should have a micro-level view of portfolio attributes to understand the risks involved.

Holistic view on credit quality

A credit quality analysis shows that most of liquid funds' assets are invested in top rated (P1+) short-term debt instruments (chart 2), highlighting safety. This apart, investors should take a holistic view while analysing a fund's credit risk. For instance, a company with a short-term rating of P1+ for its short-term issuance may have a long-term rating of below AAA (highest safety) such as A (adequate safety) or BBB (moderate safety). Taking holistic view by considering long term ratings would help investor, especially if liquid funds have higher exposure to sensitive sectors with a bleak outlook or debt-laden companies which face the risk of rating downgrades. Here's how it works - if a company's long-term rating is downgraded, the liquidity risk increases even for the company's short-term issuances, ultimately adversely impacting the fund's performance.

Chart 2: Credit quality distribution

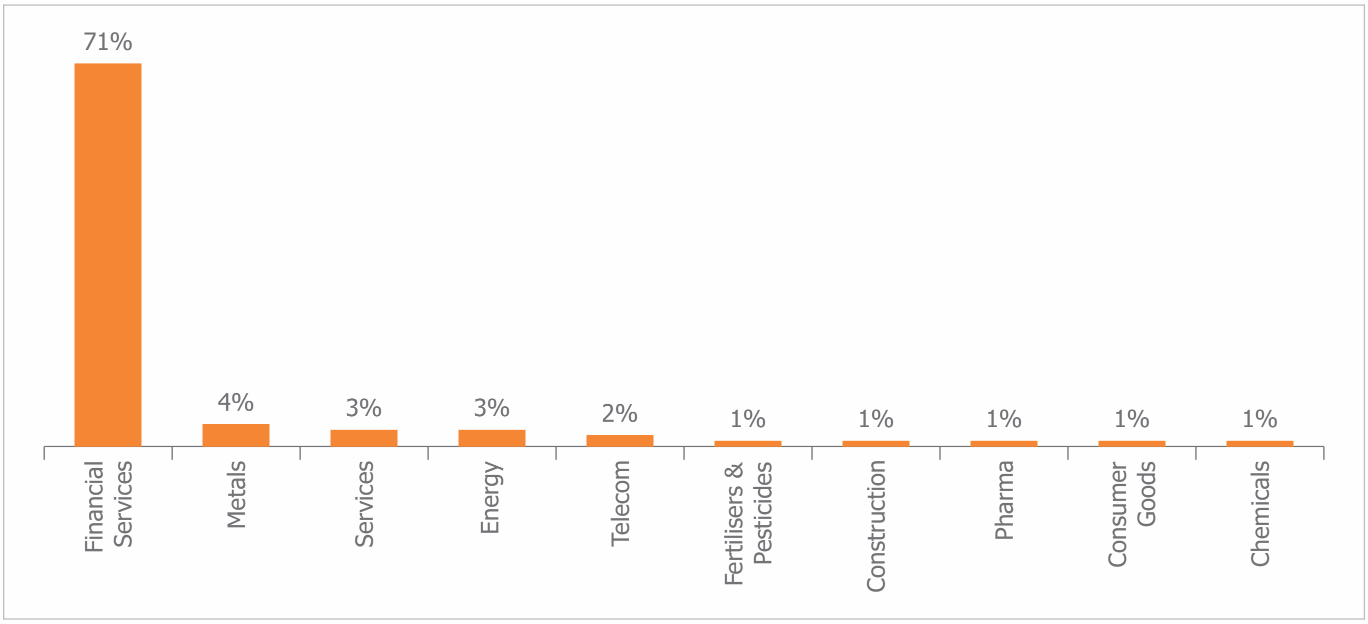


Others include: Reverse repo, CBLOs, net receivables, FD, BRDS, Call, MF units.
Portfolio data as of February 2016.

Gauging concentration risk at issuer/ sector level

Investors should gauge the concentration risk arising out of improper diversification of the portfolio. Most liquid funds have high exposure to the financial services sector (chart 3) particularly banks, financial institutions, NBFCs and housing finance companies as they are considered safe. However, to garner higher returns, funds may take higher exposure to a sector/ issuer exposed to relatively high credit risk (commodity or cyclical sectors such as metal, construction and chemicals), which may impact the fund's liquidity. In order to reduce credit risk and increase diversification, market regulator Securities and Exchange board of India (SEBI) has recently tightened norms for debt mutual funds.

Chart 3: Top 10 sector exposure of liquid funds



Portfolio data as of February 2016

3. As per CRISIL Research's categorisation.

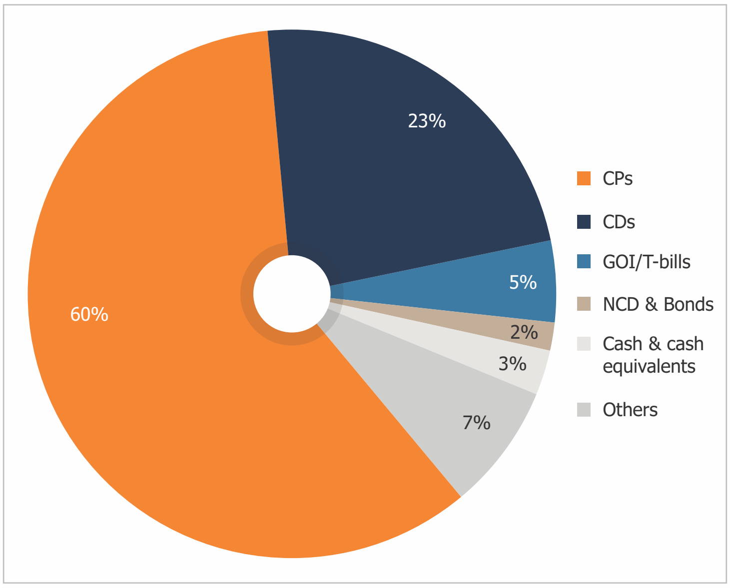
New SEBI's regulations

- Exposure limit to a single issuer restricted to 10% of net asset value or NAV (12% with trustee approval) and 20% at group level (25% with trustee approval).
- Exposure limit to a single sector lowered from 30% of NAV to 25% of NAV and additional limits given to housing finance companies (HFCs) lowered from 10% to 5%.
- Exposure to HFCs restricted to 25% of NAV.

Liquidity is also a function of asset mix

Analysis of liquid funds' asset allocation shows major part of the total assets is invested in CPs (Chart 4). However investors should note that corporate CPs are relatively less liquid than bank CDs. To boost performance, a fund may take higher exposure to CPs as they carry higher yields vis-à-vis CDs. Similarly, some funds may deploy most assets in cash and cash equivalents to maintain high liquidity, albeit at the cost of returns. Investors who want Safety should look at funds with lower CP exposure and higher CD exposure.

Chart 4: Asset allocation



Cash and cash equivalents include reverse repo, CBLOs, net receivables, Call, BRDS. Others include FDs and MF units. Portfolio data as of February 2016

Fund managers of liquid funds strive to outperform by judiciously investing in various short-term instruments pertaining to different issuers and sectors based on liquidity and credit quality. Hence risks/returns vary as per a fund's investment strategy. In any case, liquid funds have the lowest risk among debt mutual funds. However, they do carry a marginal risk as already mentioned and investors should take investment decisions based on their returns, liquidity and safety expectations.

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