

# Is a cap of MF redemption justified?

## Investors must appreciate underlying cause

**W**E ARE living in extraordinary times. The events that have unfolded globally have been far worse than anything the best risk managers could ever plan for. The deviation from the mean—in terms of change in human behaviour, widening of credit spreads, tendency to hoard cash and the scale of panic—has been of such magnitude that even the synchronised effort of multiple governments, central banks and policymakers have had little palliative effect.

The tremors of the events in the US and Europe were felt as far as Singapore and Hong Kong where sovereign guarantees had to be issued to prevent flight of bank deposits. It is easy to talk about Black Swans, but if everyone starts to budget for such multi-sigma deviations, portfolio construction will get too difficult and returns will tend to be quite sub-optimal, even on a risk-adjusted basis. While a housing downturn in the US was an issue long talked about, the consequent devastating effect on far-flung credit markets like India was not in the realm of anyone's imagination.

It is common wisdom that if all depositors withdraw their money in a bank together, leave aside the liquidity issues, the solvency of the institution will be at risk. Thankfully, for mutual funds the risk is one of liquidity alone. In a marketplace where liquidity gets as tight as it did in the past few weeks, the value of bonds, commercial papers and certificate of deposits, regardless of the underlying credit rating, tends to erode and their sale becomes difficult. A fire-sale would necessarily mean that the best price cannot be secured. If any portfolio manager is forced to do so, it is detrimental to the interests of all unit holders, including those that stay invested.

It is appropriate, fair and equitable that the fund houses take decisions that are for the collective good of all investors. Prima facie, a cap on redemptions is unpalatable, but investors will need to appreciate the underlying cause and the context in which such an unpalatable decision was taken. The RBI's timely liquidity injection and its aggressive 250 bps CRR cut have helped substantially ease the tightness in the system over the past week and hopefully, mutual funds would not face a similar predicament in the near term.

## It is negative for investor sentiment

**P**EOPLE are more concerned these days about return of capital than return on capital. In such times, a limit of Rs 1 lakh per scheme per business day on redemption only raises level of uncertainty. Large-scale redemptions from fixed maturity plans (FMPs) and fixed-term plans (FTPs) would mean liquidation of some fixed income securities from the basket of securities. In the current scenario where liquidity is tight, these securities may not get a fair market price and may have to be sold at a loss. The other concern is investments in FMPs/FTPs is made in a basket of debt papers that mature in line with

the duration of the schemes' tenure. A fund manager may find managing this period very tough. Thus, the interest of the residual unit-holders may be adversely impacted.

It all comes down to hurting a few versus possibly hurting a lot. If a particular AMC allows these redemptions, there is a chance that the residual unit holders may get hurt. However, if it disallows or limits these redemptions, then the fear factor that has the potential to spiral out of hand, may lead to a mass exodus from these funds, which due to tight liquidity in the system may not get 'efficient market' prices and hence unit-holders of a large number of schemes get hurt.

Thus, disallowing or limiting severely the amount allowed to be redeemed is quite negative for the sentiment of investors in marketplace. I would

advocate lifting this ban on limits and trusting the government to create enough liquidity in the system to be able to absorb sale of debt papers. Even if some unit-holders get hurt in the short term, it will be short-term pain for the long-term and larger gain for investors as a whole.

Finally, in addition to softening liquidity in the market through various measures, the RBI may also look at intervening in the market by offering to absorb high-grade papers held in various schemes at fair prices to prevent their sale at very low prices in wake of huge redemptions. Such a move can certainly restore confidence in the system very quickly as most of the papers held by MFs are high-grade papers. This additional comfort from the RBI, may help in reducing anxiety amongst investors and thereby reducing mass exodus and improve liquidity earlier than expected.

## FACE-OFF



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