

# **CAN YOU TRUST YOUR FUND MANAGER?**

How the mutual fund industry significantly eroded investor confidence —  
and what it now needs to do

APRIL 2008

Two fund managers raise the issue of asset-liability mismatches at AMFI general body meeting. Others shout them down saying these mismatches are just a way of making more money

MAY 30

Average assets under management of the **35 mutual fund houses** in the country cross the **Rs. 6 lakh crore** mark

JUNE 30

Three real estate companies default on payments of about **Rs. 500-600 crore** to three mutual funds. The funds accept new debt paper with higher interest rates

SEPTEMBER 1<sup>st</sup> WEEK

Large investors begin to withdraw money from liquid and short-term debt funds to pay advance tax. Nothing unusual, as it happens every year

SEPTEMBER 15

Lehman Brothers goes belly up. Panic spreads across world markets and banks stop lending. In India too, credit disbursements come to a halt

SEPTEMBER 29

Several members present at an AMFI meeting want to close down FMPs. There is finally a show of hands and nearly half the members raise hands in favour. But matter ends inconclusively

SEPTEMBER 29

Liquidity dries up. Banks borrow over **Rs. 90,000 crore** from the RBI's short term borrowing window known as overnight repo. The average borrowing in the previous days hovers near **Rs. 70,000 crore**

SEPTEMBER 30

Redemptions in the month total to about **Rs. 46,000 crore** Inflows completely dry up, pushing several debt funds to the brink

SEPTEMBER 30

Property developers are in a severe cash crunch and many reportedly tell MFs that they can't pay. The obligations are again rolled over at higher interest rates

SEPTEMBER 30

RBI reassures depositors and the general public about the soundness of ICICI Bank, which is caught in a web of rumours predicting a collapse

OCTOBER 1

The High level committee on capital markets, including RBI, SEBI, IRDA meet. The issue of mutual funds' liquidity crunch comes up. No decision taken

OCTOBER 6

RBI cuts CRR by **50 bps**; Follows it up by another **100 bps** cut four days later

OCTOBER 10

RBI governor makes statement on Indian financial system's soundness

OCTOBER 13

AMFI chief A.P. Kurian meets SEBI officials. Says MFs need liquidity support. Kurian and SEBI officials meet RBI officials

OCTOBER 14

RBI lifts ban on bank lending to MFs against certificates of deposits

OCTOBER 15

Central bank cuts CRR by another percentage point; Institutes special short-term borrowing window of up to **Rs. 20,000 crore**

OCTOBER 30

The average assets managed by the mutual fund industry falls below the **Rs. 5 lakh crore** mark and end at **Rs. 4.31 lakh crore**

NOVEMBER 1

RBI cuts CRR again; relaxes bank lending norms for MFs and NBFCs to ease liquidity crisis

NOVEMBER 7

Lotus Mutual Fund wilts under liquidity pressure; Religare buys out troubled fund

NOVEMBER 17

SEBI chairman meets AMFI board members; asks them to recommend reform measures for all debt schemes within a week

NOVEMBER 21

AMFI circulates recommendations of the core committee on debt schemes headed by Nilesh Shah of Prudential ICICI

DECEMBER 4

SEBI bans premature withdrawals in close-ended schemes; mandates investment in matching tenure

Dinesh Narayanan

**The inside story of how mutual fund houses played dangerously for bigger asset sizes and got caught in a crisis**

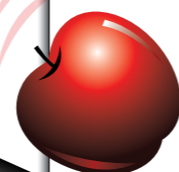
Imagine diving headfirst from a high springboard only to realize halfway that water has leaked out of the pool. The managers of India's mutual funds find themselves in a similar situation today. They can hardly complain about it, because they had been forewarned of the risk.

The empty pool in the mutual fund industry goes by the name of Fixed Maturity Plan (FMP), a close-ended debt investment plan that the industry used to pad itself up, but which eventually brought it down to its knees. (See Graphic: How Do FMPs Work). Now it emerges that all the steroid pumping by asset managers was pushing them closer to the edge.

"It was plain for all to see that we were playing a very dangerous game," says the chief executive officer of a mutual fund, recalling the unrestrained growth of FMPs over the past four years when funds continually pushed the boundaries of risk and competed with each other to be the larger fund house.

As the economy boomed, money started to flow to debt and equity markets as companies. High networth individuals sought out instruments to park their surging profits and surplus cash. Making money in the market appeared almost

# A FUND OF TROUBLES



Managers assumed that since they imposed a penalty on premature withdrawals, no investor would pull out before maturity

natural and mutual funds were in the middle of the game. While the high rollers were in the equity markets attracting most of the media attention, FMPs – a little known system then – wormed their way into the heart of the mutual fund industry.

By nature of the product, FMP fund managers should match the tenure of money coming in and the money being invested, so that the scheme can be closed out in the end. But as more and more money started flowing in, managers devised a way to increase their profits by investing short-term money in long-term securities. For instance, a fund would invest a chunk of the money collected for three months in securities that would mature only three years later. Such a ploy creates an asset-liability mismatch which is low-risk in times of easy money, but extremely risky during tight money conditions. The mismatch did not matter as long as the funds were able to float new FMPs when old ones matured and repay previous investors with the new money while transferring the securities in those funds to the new ones.

They were playing for high stakes, blindfolded.

As early as April this year, a full six months before Lehman Brothers went bust, the Association of Mutual Funds in India (AMFI) held a general body meeting where a couple of fund managers raised the red flag on the emerging asset-liability mismatches in short-term debt funds. But with the market coming off a bull run that had lasted an astounding four years, the doves were shouted down.

The doubting fund managers pointed out that the Reserve Bank of India was pushing up interest rates by tightening systemic liquidity which might lead debt plans, especially those with a fixed investment period, into trouble. They were countered by the hawks who spouted theories on risk and reward. “The only way to make money is to take that risk,” one fund manager said at the meeting.

**AN ASSUMPTION GONE WRONG**

It was the abundance of cash that fueled the popularity of FMPs. They offer better returns than bank fixed deposits and come with tax advantage too. While returns from fixed deposits attract income tax of over 33 percent, the peak rate at which FMP returns are taxed is at least a third lower. At their peak, these debt plans accounted for about 30 percent of mutual fund assets in the country.

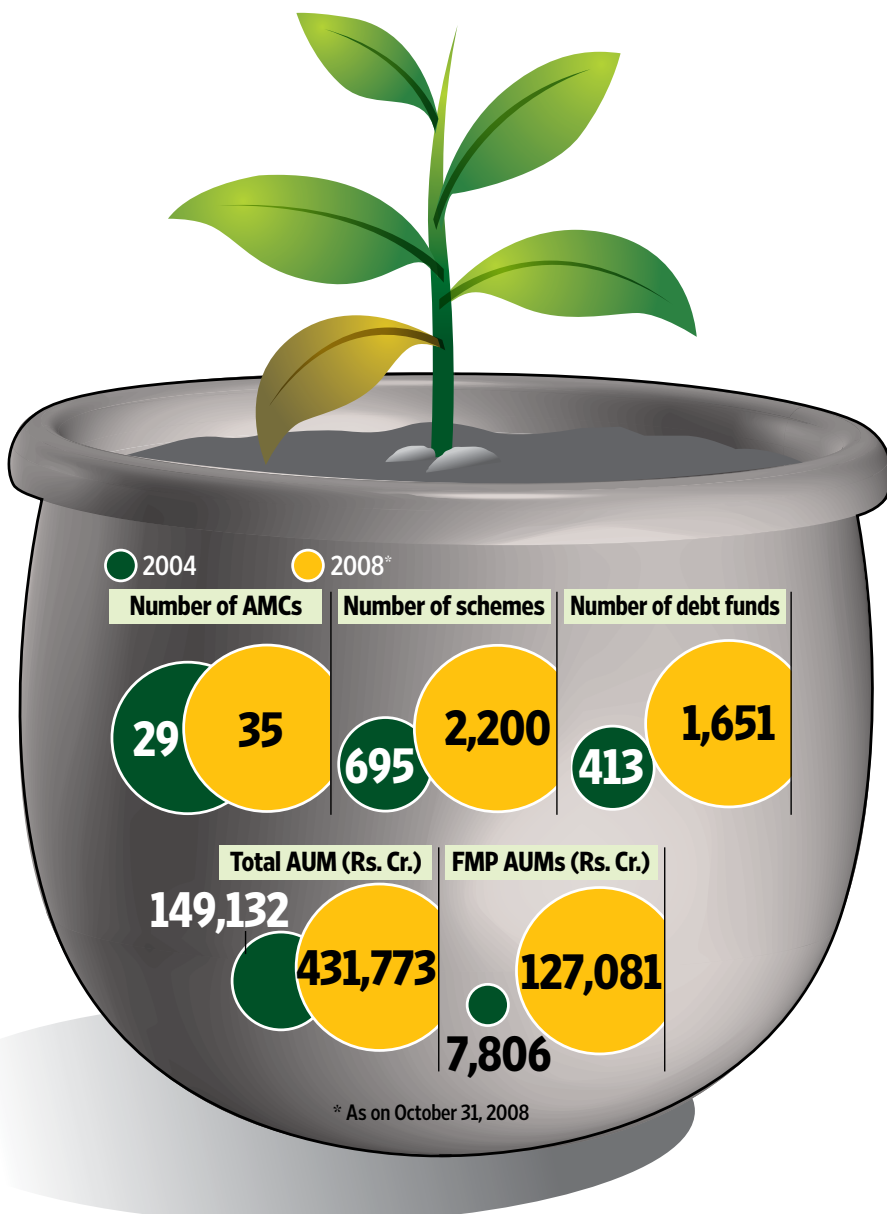
Managers assumed that since they imposed a penalty of 0.25-2 percent on premature withdrawals, no investor would pull out before maturity of the fund. But then Wall Street got a sneezing fit and the flu spread worldwide, even to ‘insulated’ India. The panic was so intense that even seemingly wise investors scampered like cats stranded on a hot tin roof.

“Some of our investors whom we serviced for a decade and with whom we are completely transparent and disclosed our portfolios totally acted foolishly. One would not expect such an irrational decision from a non-retail investor,” a fund manager told mutual fund monitoring firm Value Research in a recent interview.

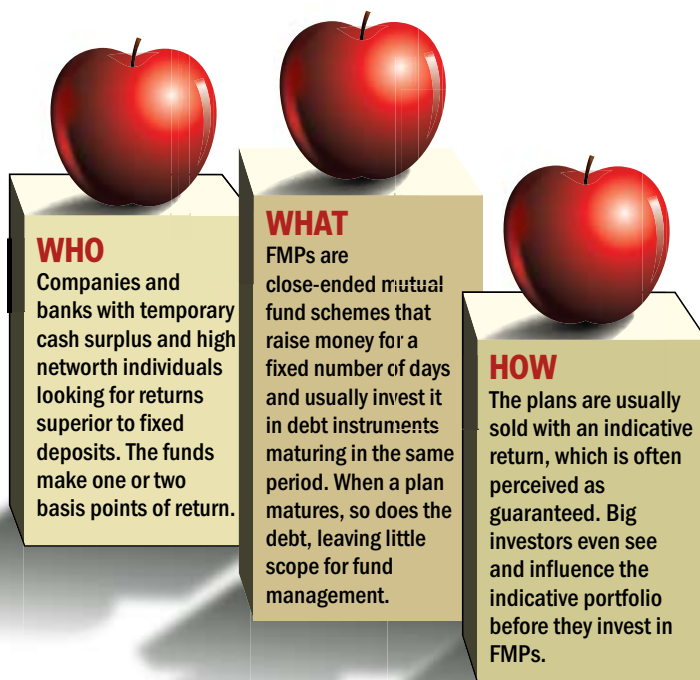
Meanwhile, red ink was spreading on the asset side of the balance sheet too. Many funds had lent large sums to property developers in the hope of earning high returns as they were borrowing money at exorbitant interest rates. The exact amount that funds lent to the real estate sector is not available, but industry experts estimate it at somewhere between Rs. 7,000 crore and Rs. 10,000 crore.

The liquidity crunch had first hit developers, who had already borrowed heavily to fund scores of new projects announced in times when cheap home loans and commercial expansion had fuelled an unbridled building boom. As interest rates rose, sales began to fall and finally the bubble burst. In the last week of June, mutual funds got a preview of things to come.

Three large property developers could not repay loans when they fell due on June 30. They said they needed more time to arrange the money. A deal was made for the funds to refinance the companies at higher interest rates to repay the old loan, a practice called ever-greening. In later months many funds were to



## HOW DO FMPs WORK



At an AMFI meeting, many fund managers called for shutting down FMPs. There was a show of hands but the meeting ended inconclusively

go down the same path to protect their assets from becoming duds.

Nothing much changed in the next few weeks, though money became scarcer as the last month of the second quarter of financial year approached. As happens every year, companies began to withdraw their investments in liquid funds in September to make advance tax payments. Then, on the 15th, Lehman Brothers filed for bankruptcy, sending shock waves through the global financial system. Markets crashed worldwide and banks stopped lending.

Most state-owned banks stopped disbursing even sanctioned loans. Call rates began to rule well above 10 percent and borrowers were crowding at the RBI's short-term lending window. It was lending anywhere between Rs. 60,000 crore and Rs. 75,000 crore each day, compared to the usual couple of thousands. The financial system virtually had a seizure as credit lines were blocked completely. Those who had borrowed against shares were frantically looking for money to save their holdings as stocks fell to new depths.

The credit squeeze forced mass withdrawals from mutual funds' liquid schemes and short-term funds as needy companies and businesses scrambled to raise finances to keep their outfits running. Investors withdrew about Rs. 46,000 crore from short-term debt funds in September. The bank accounts of debt funds were practically empty as new investors stayed away. There was also no way that funds could raise money selling the securities they held. "The underlying debt market is illiquid. That is a fundamental flaw in the fixed income market," says Dharendra Kumar,

chief executive of Value Research.

Financial markets took another beating when rumours about trouble brewing in ICICI Bank – the country's largest private lender – started doing the rounds. Investor confidence was badly mauled and the central bank had to issue a statement on September 30 reassuring depositors and markets about the soundness of the bank.

At an AMFI meeting the previous day, many fund managers had called for FMPs to be shut down. There was a show of hands where nearly half the members present voted in favour. The meeting ended inconclusively. By then many real estate developers had let funds know that they would not be able to meet the repayment schedule of September 30 as well. The debt positions were rolled over again.

### EMERGENCY RESPONSE

On October 1, the high level committee on capital markets that includes Securities and Exchange Board of India (SEBI), RBI and Insurance Regulatory Development Authority (IRDA) met to take stock of the situation. SEBI asked for liquidity support for mutual funds but the central bank remained non-committal, merely saying that it would look into the matter.

The rumours about ICICI Bank continued to spread in the market and foreign and local investors hammered down the stock. In the second week of October, according to sources, the RBI informally asked ICICI to meet its liquidity requirements without using the central bank liquidity window. (An ICICI Bank official denied it, though). On October 8, the bank withdrew a little over Rs. 2,000 crore of its investments in mutual funds. The same day, portfolio investors are also believed to have withdrawn some large deposits kept with the bank for repatriation. The bank also borrowed heavily from other banks in the call money market to meet its requirements.

As the crunch began to hurt, the finance ministry and the central bank headed to the war room. The RBI finally cut the cash reserve ratio (CRR) on October 10, pumping in Rs 20,000 crore. Four days later, it cut CRR by another percentage point even as the RBI governor reassured the public that the Indian financial system was safe. However, money was still not reaching mutual funds as investors continued to withdraw from debt funds and lending sources were nowhere to be found.

The industry went into a tizzy. Fund managers consulted one another and AMFI. On October 13, a delegation led by the association chief A.P. Kurian met SEBI officials. Kurian was accompanied by Milind Barve, managing director, HDFC Mutual Fund, A Balasubramaniam, chief investment officer, Birla Sun Life and Sandesh Kirkire, CEO, Kotak Mahindra Mutual Fund. They gave a blunt message to SEBI – debt funds were teetering on the brink. If the fund houses suffered, their sponsors – some of them non-banking finance companies and also big borrowers from mutual funds – would also suffer.

When the industry representatives met RBI officials, they did get a patient hearing from the regulator. The funds pointed out that their sector had to face redemption within a day or two. "If

The banks were asking for 20-24 percent interest rate. There was no way funds could borrow at those rates

there was no liquidity and the ability to sell assets (was) also constrained, redemptions cannot be met," said an industry representative.

The mutual fund industry itself had parked around rupees two lakh crores with banks as deposits and with this fact they could impress on the central bank it was only legitimate that they be given a special facility. The backdrop against which they were asking for special support helped them. Banks, the only possible lenders, were themselves borrowing Rs. 75,000 crore from the RBI.

"How will you repay, who will you repay, who will take the credit risk and what is the size of fund requirements," were the questions RBI asked. AMCs wanted money against the certificates of deposits they were holding and the RBI didn't see any problems of guarantee on the money lent.

Next morning, the central bank lifted the ban on bank lending to mutual funds against certificates of deposit. A day later, it threw a lifeline to the industry by instituting a special lending window for up to Rs. 20,000 crore. AMFI quickly pushed the Indian Banks Association (IBA) to send a message to the industry that banks were willing to lend. IBA called a press conference with two PSU bank chairmen assuring that they would lend money to AMCs. But, another surprise was in store for the funds.

Banks, faced with tight liquidity conditions themselves, wanted high return for their money. "They were asking for 20-24 per cent interest rates. There was no way we could borrow at those rates," said one fund manager. It didn't help that funds had lured away bulk depositors from banks with the promise of higher returns in FMPs.

**THE NOOSE TIGHTENS**

For some, it was the end of the road. News began

to circulate that Lotus Mutual Fund was up for sale. Lotus had been badly hit by redemptions and it required about Rs. 500 crore to tide over the crisis. Its sponsors, Temasek Holdings and Sabre Capital, were unwilling to bail it out. Finally Delhi-based Religare Aegon came in for rescue. It first pumped in money to bail out the fund before announcing the takeover.

Another large fund was bailed out by its parent, a large non-banking finance company, by buying a part of its portfolio for about Rs 600 crore. The bailout is believed to have cost the finance company heavily as it was in the market a few days later borrowing money from two state-owned banks at an annualized interest rate of nearly 20 percent.

As the worst appeared to pass, the regulator called the mutual fund association for a meeting on November 17. SEBI Chairman C.B. Bhavé gave industry representatives a week to come up with suggestions to bolster the industry's structure and improve prudential measures. Whatever happens, "investors should not suffer", Bhavé is said to have told them.

AMFI immediately formed a panel headed by Nilesh Shah of ICICI Prudential and within four days, came up with a set of recommendations. On its part, SEBI moved to ban premature withdrawals in close-ended funds and mandated that schemes invest in paper with a similar tenure as their own. All close-ended schemes will have to be listed on stock exchanges so that funds don't take the brunt of redemption pressures. Now the industry could breathe easy.

The crisis will doubtless leave a lasting imprint on the mutual fund industry. Measures will have to be put in place to ensure that they don't take such risks with people's money. What Gordon Gecko in the movie *Wall Street* said was wrong. Greed is *not* good. ■

**FIRE FIGHTERS**

Duvvuri Subba Rao



The new RBI governor began his term at Mint Street fighting fire in the midst of an unprecedented global economic crisis. According to some, he followed directions from the finance ministry, frequently flying to Delhi as the cash crisis deepened in October and November. He, however, acted quickly when mutual funds ran to him for help.

A.P. Kurian



The septuagenarian has been the face of the industry association for a long time. Kurian was instrumental in getting SEBI and RBI to act when funds were hit by mass withdrawals in September and October. Industry sources say that he had been advising caution for some time, but many members refused to listen.

C.B. Bhavé



The soft-spoken, no-nonsense former bureaucrat took over as chairman of SEBI in February when the stock market had just come off its peak. Blame it on the stars, but Bhavé has since witnessed one of the worst stock markets routs ever. He made clear one commandment when AMFI went to him: whatever happens, investors should not suffer.

Nilesh Shah



The charismatic fund manager at Prudential ICICI was quite prudent when it came to picking assets in FMPs run by his asset management company. He says the plans stayed away from exposure to real estate firms. He was also the coordinator of the core committee AMFI constituted to suggest reforms in debt schemes.



# Looking for A LASTING CURE

**Policy changes have made a start, but the mutual fund industry needs to go further to avoid a repeat of the crisis**

M.C. Vajjayanthi

**W**hen the debt fund storm hit the mutual fund industry, it took the combined efforts of RBI and SEBI to save it. But now that calm has returned with the help of cash infusion and tighter rules for investors, some fund managers are underplaying the enormity of recent events. It was a passing liquidity problem that has been solved, they argue. But, is that all?

There are other mutual fund veterans who say the crisis brought to light more fundamental shortcomings that mutual funds had gathered over time. As the Indian economy brimmed with cash surpluses in the past four years and fund managers competed with each other to garner

more investible funds, discipline, transparency and governance fell as victims. If another crisis is to be avoided, funds should introspect and go back to basics, they say.

India's oldest mutual fund, UTI, is perhaps taking the lead in questioning the industry's practices, especially in selling and managing FMPs. "There was no transparency. Misselling used to happen. How healthy was the system we were building? Was there a compromise on quality?" asks U.K. Sinha, UTI's chairman and managing director.

Already, some solutions have started coming in. In the first week of December, a few days after AMFI circulated its set of recommendations to streamline the FMP system, SEBI mandated that all close-ended schemes, including FMPs,

be listed on the stock exchanges. It also prohibited premature redemptions on such funds, making the exchanges the only route for early exit.

The regulator's moves have addressed one facet of the problem, namely a liquidity crunch that could result from a run on a close-ended fund. After all, the recent crisis was marked by such large-scale early withdrawals. Henceforth, an investor would have to go and sell the units in the stock exchanges only.

While SEBI has advanced a limited solution for the cash flow worries of funds, it is yet to address the larger problems that investors are worried about. Also, close-ended funds suffer low liquidity on the exchanges and finding a buyer for an FMP will be very difficult. Even if a buyer is found, the market price could be lower than the net asset value, forcing a discount on the seller. These lacunae could drive away investors from such schemes. Perhaps for this reason, even AMFI's discussion paper had recommended only increasing the exit charge rather than a complete ban. "It is going to be tough for anyone to come up with FMPs in the current situation," says D.D.Rathi, whole-time director and CFO (Chief Financial Officer), Grasim Industries.

SEBI chairman C.B. Bhave himself maintains that these are only the first set of measures to deal with what was immediately possible and necessary. More decisions would be taken in due course to streamline the debt fund market, he said.

He has a handful of issues to look into.

### A MATTER OF DISCIPLINE

FMP managers have often invested in debt papers with a term longer than the scheme itself, to earn higher returns. This meant that the amounts would be still locked in when a scheme closes and investors ask for money. The fund house would pay the investors with money from its cash flow outside the scheme. This was a dangerous ploy, betraying a lack of prudence. "As far as mutual fund and their crisis in India is concerned, it is due to bad product creation. Any product that allows non-transparency is a bad design," says Nachiket Mor, head of ICICI Foundation. SEBI has now made it mandatory for schemes to invest in paper that matches with the tenure, hopefully ending the vicious spiral.

But there are other practices that have come under scrutiny.

The first thing being questioned is the funds' practice of giving indicative returns. The debate is whether it is a market sin: guaranteeing returns. Since the maturity period of an FMP is fixed, given its close-ended nature, funds got into the habit of giving indicative returns to attract investors. Several fund houses would launch their FMPs on the same day and each would need to make some unique proposition to win attention. A higher interest return, indicative of course, was a sure bet.

The mutual fund industry, however, defends the practice of indicative returns. "The investor comes with a locked-in maturity. Till now, there is not an AMC which has not delivered indicative returns," asserts Nilesh Shah, deputy managing di-

rector and chief investment officer at ICICI Prudential Mutual Fund.

But what did it entail? Mutual funds had to stretch their investment strategy to include paper that would yield higher returns. The risk profile, too, would then get enhanced. But in times of abundant cash, risk is relegated to a theoretical study and the investors keep signing in.

Another vortex that fund houses can get sucked into is the extra commission that they pay to distributors. Given the very low fee structure in India, and the ceiling imposed by the regulator on the commissions, fund houses shouldn't be overpaying the distributors at all. As Ashu Suyash, CEO (Chief Executive Officer) of Fidelity Mutual Fund, points out, high commissions create an imbalance in the market and distributors favour those paying higher.

But the reality of competition and the inability of mutual funds to expand their own network beyond a point, force them to depend on distributors to push a scheme into the market.

Third-party distributors are a powerful lot in deciding the future of a scheme. This has led to the nearly three dozen AMCs competing with each other in pampering distributors. AMCs pay commission out of their pockets over and above what they can pay from the official expense ratio. This cuts down their profitability. This is where the need for regulating distributors has arisen.

Capital adequacy is one of the safeguards against liquidity problems. As

FMP managers have often invested in debt paper with a term longer than the scheme itself, to earn higher returns



Did all the growth happen in debt schemes due to the superior fund management capabilities? It was because of the tax incentives corporate treasuries got

- UTI's U.K. SINHA

things stand, the networth requirement of AMCs is a mere Rs. 10 crore, even if the assets exceed tens of thousands of crores. "SEBI should, as it is presently considering, prescribe prudent networth requirements that would enable AMCs to meet liabilities," says Cyril Shroff, managing partner at Amarchand & Mangaldas & Suresh A. Shroff & Co.

#### A MATTER OF TRANSPARENCY

At the time of launch, an FMP typically gives an indicative portfolio to give investors an idea of where their money would go. But in some cases, the actual portfolios were found to be different from the indicative portfolios.

The opinion increasingly within the industry is that fund managers should resist floating model portfolios and just stick to a broader outline. "Though it is possible to give a model portfolio in a fixed income product, it need not be indicated in full. It is enough if the fund says where it is mandated to invest – broad categories like bank FDs, debt of manufacturing companies," says T.P. Raman, CEO, Sundaram BNP Paribas Mutual Fund.

But more serious are the instances when FMPs had strayed from their declared mandate and invested in more risky debt or a different mix of paper. This considerably changed the risk profile that the investor had not committed to. So, the first solution being proposed in the sector is for SEBI to ensure that FMPs follow their mandate strictly.

With six months to declare the portfolio, debt funds have a lot of time to play around with the mix of investments. So, the frequency could be reduced to just one month, which will bring in more transparency. Another idea is to require a disclosure as and when a significant change is made in the portfolio.

It is the lack of information that breeds panic. Investors will assume the worst when they don't know the facts. A distributor who has been selling mutual fund products for over a decade said he had never perceived FMPs to be risky. But when reports about FMP problems appeared in the media, he wanted to ensure the schemes in which his clients had invested remained safe investments. Also, "I have told my clients to keep away from FMPs temporarily".

#### A MATTER OF GOVERNANCE

"Did all the growth happen in debt schemes due to the superior fund management capabilities? It was because of the tax incentives corporate treasuries got," UTI's Sinha asks. Companies and high-networth individuals flocked to FMPs because the tax burden is lower than that on the returns on fixed deposits. Sinha

calls for abolition of this tax benefit, so that the funds would sell FMPs and investors would put in money for what they're.

Misselling took different forms. "I am aware of cases where people are sold instruments that are not relevant to them," says a distributor. In one instance, a trust was lured to invest its entire corpus of Rs. 1.5 crore in a single scheme, a concentrated bet that the trust may not be able to sustain.

No amount of regulatory oversight can bring in order to mutual fund industry as self-regulation can. A few months ago, SEBI began a discussion on the role of trustees in AMCs. Now, mutual fund trustees play a role similar to independent directors on company boards.

In a three-tier mutual fund business structure, trustees are supposed to play the role of safeguarding investor interest. "They have the powers to demand information from the fund management at all levels – asset allocation, risk management practices, trading information," says Susan Thomas, assistant professor, Indira Gandhi Institute of Development Research.

Those in the industry defend the current functioning of the trustee system, but it is unclear whether questions were raised when the FMP spree was on. Given the levels of disclosure in the MF industry today, I would not think that there is much to do by way of improving the powers of the trustees," says Thomas.

But, more than ever, the mutual fund industry faces an urgent need to spruce up the trustees system to encourage whistle-blowers and usher in a self-balancing mechanism. One of the ideas SEBI is toying with is whether a professional, independent body of trustees could be set up. This organization would do the external auditing of the way funds are run.

Opinion is divided on whether an independent body can be effective. "You cannot fix responsibility. It is your fund, your product innovation and it is only those who are looking at it specifically can be (made) responsible," says Shailesh Haribhakti, managing partner and CEO of Haribhakti Group. Some cite overseas experience to dismiss the idea of independent trustee firms. "I am not in favour of that. I run a few international funds and I know that these companies do not look (at) anything but collecting their fees," says Sinha.

Part of the problem in the mutual fund industry may be that there are too many players. It took India 15 years to get 35 mutual funds, but this year alone, 20 more queued up to set up shop. Given the limited profits, there may not be room for all. "It is not a greatly profitable industry. Intermediaries make more money," said the CEO of a new AMC. Naturally, mergers and acquisitions are inevitable.

Sinha says only players with the ability to withstand losses for 3-5 years and have the infrastructure to tap retail money on a regular basis can survive in this market.

As the industry comes to grips with the crisis, it also faces lasting changes in regulation and adverse market conditions. The loopholes can be fixed, but to regain investor confidence, mutual funds have no recourse but better discipline and good performance across markets. ■

Part of the problem in the mutual fund industry may be that there are too many players. Given the limited profits, there may not be room for all

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(India) Private ed (Liability rest Schemes. Risk Factors: All inves There can be no assurance that the Mutual Fund. Scheme class Market Instruments and Cash 0 ture: Entry - 2.25% for investm changes shall be implemented j read the addenda to the Offer I carefully before investing Inves Capital Markets (India) Private eration of the Schemes. Risk Fa rty markets. There can be no as Scheme(s) of the Mutual Fund. Debt, Money Market Instrumen Load Structure: Entry - 2.25% fc and such changes shall be imp insurance claims and how to m fully read these addenda. Mut Information Memorandums al ed (Liability restricted it the cor ing from the operation of the fa Sponsor, AMC, Mutual Fund or Objective: The Scheme seeks t truments and Cash 0 - 20%. Te Days, at the Applicable NAV. Lc entry / exit load set forth above pertaining to Free Critical Illn Eligible Schemes. Prior to maki ment carefully before investin has been set up as a trust by HS ment Company (AMC) are no subject to market risks and the that the objectives of the sche of the Scheme(s) of the Muti of equity & equity related secu period of 3 years from the dat Nil. Exit - Nil.\*No load in case emented prospectively. For the make insurance claims), please Fund investments are subject t with application forms from t pus of Rs. 1 lakh). The Sponso Schemes. Risk Factors: All inves the future performance of the S a diversified portfolio of equity demption (after a lock in perio in case of switches between equ pertaining to Free Critical Illne investors are requested to caret Memorandums along with appl or / associates of the Sponsor/ subject to market risks and the achieved. Past performance of f Scheme seeks to provide long te ble for sale and redemption (a Exit - Nil.\*No load in case of s conditions particularly pertaini making investments, investors i Key Information Memorandum 1 lakh). The Sponsor / associa securities are subject to market will be achieved. Past performa vestment Objective: The Schem and Cash 0 - 20%. Terms of Issue Load Structure: Entry - 2.25% fc ject to change at tge discretion Cover (termination of cover, di making investments, investors a investing Investors may obtain set up as a trust by HSBC Secu Management Company (AMC) funds and securities are subject as a trust by HSBC Securities an ment Company (AMC) are not i and securities are subject to m Details: Mutual Fund has been s associates of the Sponsor/ Asset Factors: All investments in mut on the factors and forces affectin the security markets. There can be no assurance that the objectives of the scheme(s) will be achieved. Past performance of the Sponsor, AMC, Mutual Fund or any associates of the Sponsor/AMC does not indicate the future performance of the Scheme(s) capital appreciation by investing in a diversified portfolio of equity & equity related securities - 80 - 100% and Debt, Money Market Instruments and Cash 0 - 20%. Terms of Issue: Units would be available for sale and redemption (after a lock in period of 3 years from the date of each allotment of Units) on all Business Days, at the Applicable NAV. Load Structure: Entry - 2.25% for investments / switch ins\* < Rs 1 crore, otherwise Nil. Exit - Nil.\*No load in case of switches between equity Schemes. The entry / exit load set forth above is subject to change at tge discretion of the AMC and such changes shall be implemented prospectively. For the detailed terms and conditions particularly pertaining to Free Critical Illness Cover (termination of cover, disbursement of insurance claims and how to make insurance claims), please read the addenda to the Offer Document of Eligible Schemes. Prior to making investments, investors are requested to carefully read these addenda. Mutual Fund investments are subject to market risk. Please read the Offer Document carefully before investing Investors may obtain Offer Documents and Key Information Memorandums along with application forms from the office. Statutory Details: Mutual Fund has been set up as a trust by HSBC Securities and Capital Markets (India) Private ed (Liability restricted it the corpus of Rs. 1 lakh). The Sponsor / associates of the Sponsor/ Asset Management Company (AMC) are not responsible or liable for any loss or shortfall resulting from the operation of the

# Fading Stars

Pravin Palande

**Investors who trusted star fund managers to outperform a bear market were in for a rude shock**

**F**or Nilesh Shah, it would have been yet another speaking engagement at an investor meet — if it weren't for the timing. This time, the mutual fund industry was banking on its star speaker to come to its defence. And the chief investment officer and deputy managing director of ICICI Prudential Mutual Fund wasn't about to let them down. The liquidity crisis in the equity market was a black swan event—it couldn't have been predicted, he said. "Investors should hold on to equities as this is the only asset that generates returns over the longer term."

Not too many investors might immediately question Shah's assertion. After all, over the last decade, the performance of equity fund managers has been unquestioned. In the last ten years (November 1998 to November 2008), the Indian market has grown by an average 12% annually, the boom years and the earlier sluggish period all told. During the same period, fund managers have generated a return of 18-20% for diversified equity funds, a good proxy for the broad market.

But that's just half the story. Things have been changing over the last five years. Beating the market isn't a cakewalk these days. And the outperformance of a fund relative to its benchmark - also known as alpha - has been falling gradually.

Sample this: overall, fund managers have given a return of 15.33% over the last five years while the markets returned 13.5%. Here, if we add a 2% dividend re-distribution that



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Why were funds unable to read the present crisis and go into cash when the markets were hovering at unrealistic highs?

an index fund investor can benefit from, then the returns from the market will be 15.5% on par with any active fund manager.

But then averages can sometimes be misleading — especially since a clutch of fund houses and their star fund managers have done far better than the average. Let's look at a set of diversified equity schemes managed by a line-up of the smartest fund managers in the country. For the sake of the experiment, we choose Prashant Jain of HDFC MF, Sukumar Rajah of Templeton, Sunil Singhanian of Reliance, Prashant Kothari of ICICI Prudential, Anup Maheshwari of DSP BlackRock MF and the duo of Anoop Bhaskar and Sanjay Dongre from UTI.

Here is what the data revealed. These star fund managers managed to return 17.5% over a five-year period—a good 200 basis points higher than the average. But then, as the index fell by 52% in the last one year, the funds managed by stars also dropped by a similar figure. The overall mutual fund industry fell 54%.

So, are the glory days of fund management over? Or is it just a temporary blip in performance? Across the board, mutual fund investors are asking crucial questions about performance. What shield have fund managers provided their investors over those who invested directly in the stock markets? Why were funds unable to read the present crisis and go into cash when the markets were hovering at unrealistic highs? After all, weren't these the folks who were supposed to have superior knowledge? They simply haven't delivered, feel many investors.

The mutual fund industry is well aware that it has its back to the wall. "It is time to build credibility one more time. We have gone back to the days of the early Nineties where there was so much mistrust about mutual funds amongst the people. We are entering the dark ages and this time, it is not going to be easy," says a fund manager. He feels that within a year's time the

industry has regressed into a state it was in almost a decade ago.

So here's the moot point: can the industry really bounce back?

**LESSONS FROM THE PAST**

The clues lie in how fund managers managed to beat the Street by a wide margin in the past. Sanjoy Bhattacharya, a former chief investment officer at HDFC Mutual Fund says that when the overall alpha generated over ten years is considered, it is seen that active fund managers have generated a return of 20% annually while the Nifty is hardly 12%. "Thus it is not because of the fact that Indian fund managers are geniuses but due to the fact that the Indian market is highly inefficient and this will continue to (be) so," he says.

Simply put, that means market prices in India have more anomalies at a given point of time, than say, in developed markets. Information does not get quickly adjusted in the Indian markets and thus there is inefficiency in the market for fund managers to exploit. A big investor or a fund manager can have extra information about a company related to its exports or product development that the rest of the market does not have. Or she may know beforehand the order-book position of a company that is exclusive information.

Blue chips and other large cap stocks, which are keenly watched by the investor community, suffer less from this inefficiency than midcaps that have a lesser level of tracking. Typically, a small number of traders can have large influence on a midcap stock than on a large cap. News leaks and event-driven rallies create imbalances in stock prices. On the flip side, liquidity can dry up more quickly on midcaps than large caps. For liquidity and relatively better price efficiency, large caps are naturally the better bet.

As star fund managers start to show performance—and their fund corpus starts to increase—the fund is forced to maintain a very liquid

Fund Name	1-Month (%)	6-Month (%)	1 Year (%)	3 Years (%)	5 Years (%)	Expense (%)	Assets (Rs. crore)	Portfolio turnover (%)	Top Ten Holdings (%)	Fund Managers
ICICI Prudential Growth	7.46	-37.64	-47.98	3.01	15.52	2.33	23.97	155.00	30.35	Deven Sangoi, Mrinal Singh
UTI Master Value	-7.82	-46.15	-55.09	-8.68	7.95	2.30	28.30	3.72	23.49	Anoop Bhaskar
ICICI Prudential Power	5.10	-43.27	-54.19	0.09	14.63	2.15	45.20	180.00	35.63	Prashant Kothari, Mrinal Singh
UTI Master Plus '91	2.21	-41.41	-54.21	0.28	12.39	2.09	62.64	19.30	29.55	Sanjay Ramdas Dongre
DSPBR Opportunities	1.42	-41.76	-52.95	1.28	17.85	2.01	77.21	61.84	19.43	Anup Maheshwari
Sundaram BNP Paribas Select Focus Reg	-4.08	-37.62	-49.59	9.58	20.17	2.38	82.90	148.00	23.72	Srividhya Rajesh
Franklin India Prima Plus	1.03	-37.31	-47.27	6.36	20.46	1.96	1148.66	57.85	28.67	Sukumar Rajah, Anand Radhakrishnan
HDFC Top 200	-0.79	-37.42	-45.63	5.28	20.59	1.88	2018.44	89.44	24.26	Prashant Jain
Reliance Vision	1.87	-39.10	-51.10	3.24	17.85	1.83	2536.84	54.00	25.40	Ashwani Kumar
HDFC Equity	-4.05	-40.40	-50.69	1.08	17.66	1.83	2896.34	87.43	25.19	Prashant Jain
Reliance Growth	-1.01	-43.65	-52.03	4.73	25.43	1.81	3567.05	97.00	19.54	Sunil B. Singhanian
Star funds average	0.12	-40.52	-50.98	2.39	17.32	2.05	1135.23	86.69	25.93	
Overall average	-0.11	-44.12	-54.27	-1.83	15.33	2.10	230.19	91.01	27.09	

Source: Value Research

As on November 30, 2008



The fund manager talks about long-term investment and Warren Buffet philosophy, but he wants to have tips on a daily basis

- A BROKER

portfolio so that it ensures a smooth exit. Besides, it keeps the operating cost for managing the portfolio down. Here again, the large cap stocks tend to be more suitable than mid cap stocks. So large funds—run by star fund managers—are forced to skew their portfolio towards large caps.

Now, that has a huge impact on returns. High return stocks, where the fund manager would perhaps have extra information on the company, also suffer from low liquidity. Thus, small funds take the risk of investing in mid cap stocks.

So how does this phenomenon impact the star fund manager's investing strategy?

#### PROMISE VS. PHILOSOPHY

Every fund has a philosophy or an objective. Under pressure to deliver higher returns than the benchmark, many funds start diverging from their philosophy of long-term investment.

In their frenzy to beat the markets, fund managers end up relying on short-term trading strategies. This basically means that they keep churning their overall portfolio to catch up with the latest trend in the market instead of holding stocks for the long-term. Portfolio turnover for all funds that have delivered more than 15% over the last five years is less than 100%. This includes the top performing funds in the market. When funds end up competing for the same stocks in their portfolio, the returns of these portfolios start to show high correlation with each other. Top funds in terms of assets have a more than 90% correlation in terms of returns over the last five years.

So if a fund does well, its performance tends to get quickly dissected and other funds end up imitating its portfolio—sometimes at complete divergence from the fund's original objective. For example, many infrastructure funds would have

banks as the top sector or a 'Gen-Next' fund has a Hindustan Lever. Or, if you notice a power fund with Bharti Airtel as its best holding, it could merely be a policy to copy another successful fund.

Even brokerages got dragged into this intensely competitive environment. Sometime ago, a broker sought empanelment with a prominent fund whose fund manager was known for his ethics in investing. He was asked to send tips to the fund management team on a daily basis every evening as a price.

"Outside in conferences, the fund manager talks about long-term investment and Warren Buffet philosophy, but he wants to have tips on a daily basis. The portfolio turnover of these funds is very high. They deliver returns by taking higher risks and not through value investment. No wonder we are seeing these portfolios losing value in these market," says the broker. He refused to fall in line and chose not to work with the fund.

"In a way, the cult of star fund managers and analysts are created by the media and distributors. These fund managers have gone wrong in the recent past yet they continue to increase the AUMs. Investors should look at creating wealth in the long-term and on strong fundamentals. Believing too much in fund managers may lead to behavioral biases," says Parag Parikh who heads Parag Parikh Financial Services. While most funds behaved similarly, it is the star fund managers whom many investors trusted to perform better.

For the investors, it is often a tough call to make whether or not to be with a fund that defies its own long-term objectives to give higher returns. Hence, the question is a difficult one and the answer to it even more so, according to Nipun Mehta, head of private banking at Societe Generale India. Says Mehta: "The fund manager has changed his strategies to give higher returns to the investor. This is right. But getting into short-term trading or defying the basic goal of the fund is wrong."

Over the last few years financial markets have gone across a lot of change. Mutual funds were based on a simple concept of diversification. Thus uncorrelated stocks should be able to generate higher returns with lower risks. Over the last two years, asset classes including foreign exchange markets, gold, real estate, stocks, oil and commodities have moved up together. This has defied the entire logic of portfolio building. Fund managers are yet to come to terms with this phenomenon. A lot of them have moved away from the traditional financial theories to behavioral finance as they feel that this new field will give them better answers to understand the market. Though this may be true that new fields will create new inroads, fund managers need to realise that all this will only make markets efficient and difficult to beat.

Mutual funds are not soap operas. There is no need for stars here. Neither there is any guarantee that celebrity fund managers will bring in superior returns. Given that they have not been able to shield their funds from colossal losses in recent months, star fund managers are sure to lose some of their aura. But there is one star that will always reign supreme on the horizon of investment. It is called prudence. ■