**An Open Letter to the CIO's Of Mutual Funds**

Dear CIO's,

The fear over debt mutual funds, and in particular, "liquid" funds, triggered by the ILFS default, has been rising to a crescendo. This is an opportune moment for us from the investor community, both corporate and individual, to share our feedback with you, on the state of affairs.

We have reposed our faith in your asset management skills, by parking about Rs 12 lakh crores with you, in the debt mutual fund category. While we may not pay the handsome fees like the equity scheme investors, we have undoubtedly bolstered your Assets Under Management, and thereby helped you in claiming your place at the high table of the financial markets in Mumbai. But it's not only an AUM game, many of the debt schemes are lucrative too, from your perspective.

In return, we ask for three things, like any other investor, including august ones like the Reserve Bank of India which invests the Foreign Exchange Reserves of the country: safety, liquidity and return, perhaps in the same order.

On the liquidity front, we observe that you have a tendency to cry "uncle" at the first sign of trouble. In 2008, you were bailed out by the central bank, at the peak of the Wall Street induced financial crisis. This time, by gorging on NBFC/HFC paper, you are facing a self-induced crisis and understandably expect the government and/or central bank to step in to bail out your NBFC friends and thereby your schemes as well. We as investors are fortunate to have such ardent champions on our behalf, who have no qualms in going hat in hand regularly to the powers that be, for a bailout. But we also have in our midst those who carp at the structural issues by way of liquidity facing the mutual fund industry, and the lack of concerted effort to address it, rather than repeatedly falling back on the expectation and hope that the system liquidity provider will step in always. These pessimists in ask the unthinkable; what if the central bank one day fails to backstop liquidity, citing moral hazard in such actions to save the private sector, and to avoid complacency among NBFC's and asset management companies.

Your reliance on the opinion of rating agencies is noteworthy. These agencies have an egalitarian approach to their fee paying customers, whose paper you buy on our behalf. "Innocent until proven guilty" goes the legal maxim. Extending this to the credit markets, rating agencies accord most large NBFC/HFC's a "AAA" rating, unless proven otherwise. The latter scenario is where the rating agencies truly prove their mettle. No sooner a default happens, they promptly downgrade the rating from "AAA" to D. It appears that the rating scale is binary in their world.

As investors we suggest that the rating reports are taken seriously by you. Reading them before going to bed, will ensure a good night's sleep. Your portfolio, as certified by these distinguished analysts is all "AAA"!

All those juicy fees dangled by the rating agencies' customers in the NBFC/HFC space for their mega CP issuance, would surely not have clouded the judgement of the agencies. But here, one recalls Upton Sinclair, the American novelist, who said that "it is difficult to get a man to understand something, when his salary depends upon his not understanding it". We therefore suggest developing a parallel rating scale of your own. We as investors have chosen to pay you investment management fees for your credit skills. For investment decisions, if you are relying largely on the opinion of analysts at external rating agencies

("all honorable men" as Mark Antony said!), then we might as well pick up the investment papers directly. As investors we would be glad to see your internal ratings and their rationale, as part of your disclosures.

Some of us who are risk averse have invested in your Banking and PSU debt schemes. We are aghast that NBFC/HFC paper have crept into their portfolio, at times. While the fine print in your legal documents may permit you to take such exposure, this is a breach of faith, from our investor perspective. When the name of the scheme implies one thing, while the portfolio is something else, then all trust breaks down. Investors will never forgive you for losses if any, in our Banking and PSU debt schemes, on account of exposure to NBFC/HFC paper or for that matter, any non-bank/non PSU investment. The same holds good for gilt schemes too. We also urge you to research on the fiscal deficit and other parameters of state governments, impacting repayment of their State Development Loans.

Basel compliant Additional Tier 1 bonds issues by weak PSU banks, especially those under the ambit of the regulator's Prompt Corrective Action mechanism, are best avoided, despite their attractive yields. The Basel III norms do not permit payment of interest on such bonds, unless the issuing bank has sufficient distributable reserves. Given the bottomless pit that NPA's are turning out to be, these banks, to be Basel compliant, may have to either default or prepay the bonds with the help of the Government. While the latter route has been taken thus far, do not bet that this will continue forever.

We urge you not to expose us to duration risk in gilt funds. Your track record in dynamic bond schemes, which play on duration, is nothing to write home about. Most of you are rarely able to get the rate cycle correct on these dynamic bond schemes. Therefore, sticking to a portfolio of predominantly short term Treasury bills and Triparty repo through CCIL would remove both volatility and credit risk from the Gilt schemes. We are not greedy, we appreciate that such a portfolio will produce modest returns, but that's the price we are willing to pay for safety.

We note that the current crisis has seen a manifold increase in the AUM's of overnight funds. AMC's who do not offer these schemes are rushing to launch them. The industry at last is realizing the true meaning of a liquid fund and its ideal portfolio. Keep away anything other than reverse repo and CCIL's triparty repo from the portfolio of overnight funds. As normalcy returns sooner or later to the money markets, we trust that you will not dump your favorite NBFC paper in overnight funds, taking refuge in some obscure fine print in the scheme information documents. The current crop of liquid funds, stuffed with "AAA" rated NBFC/HFC paper, are best reclassified as Credit Risk funds (of low duration).

One of the biggest worries that we as investors in debt mutual funds face, is the fear of being the "residual or last investor" given the open ended nature of most of the schemes, barring fixed maturity plans. If a portfolio has 75% liquid/credit worthy paper, and faces a run, the first 75% of the investors who choose to press the redeem "panic button" and run for the exits, get 100% of their money back. The last 25% is stuck with the illiquid and dubious paper, and face potentially a 100% loss. Most investors are aware of this, hence any market rumour of a NBFC/non-financial corporate defaulting, will see a run on schemes which have exposure to it. The contagion can then spread to other schemes and then to the wider money markets, potentially leading to a grid lock, not unlike the extreme distress scenario witnessed during the dark days of the 2008 global financial crisis. We are currently seeing a mini version of this in India. The industry needs to work with the regulator to address this structural issue, on a war footing basis.

**CONCLUSION**

Your business model is enviable. Rating agencies are there to do credit assessment on your behalf, and the guardians of the financial system to handle your systemic liquidity problems in an extreme scenario. And unlike banks, you don't have the Basel norms for capital adequacy to meet nor any reserves to keep with the central bank. If investee companies default, you pass it on faithfully to us, by marking down the daily NAV. Since all of you have near identical portfolios, there is no real individual reputational risk too. Rarely does a business produce such returns to shareholders, with negligible skin in the game. But we have a word of caution for you. The minority in our midst, are prone to lament about the investment management fees we pay you, and the value that you bring to the table. Before their voice becomes a majority, we urge you to introspect on all these facets, once the current crisis blows over.

A final word. If the government ever eliminates the tax arbitrage arising from long term capital gains benefit for investment in debt mutual funds, which is currently not available for direct investments in fixed deposits and other debt instruments, your very *raison d'etre* would be in question, and would require you to find a new business model or fade away into oblivion.

With best regards.