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Mon, 12 Mar-18; Mint - Delhi; Size : 525 sq.cm.; Circulation:21050; Page : 14

Short-term funds in long-term portfolios

Everyone knows that investing should be for the long term. Should you then invest in funds that hold securities maturing in 30-60 days? You should, and here is why

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DSP BlackRock Liquid ETF is the new kid on the liquid fund block. Exchange-traded funds (ETFs) are listed and traded on exchanges just like other stocks and bonds. However, rather than being just one security, ETFs are structured as a fund or a basket of securities put together with a specific investment objective. For liquid funds, the objective is to deliver steady returns with very low volatility. Put together, you get a low-risk daily return option that can be traded on exchanges. DSP BlackRock Mutual Fund has positioned this fund as a convenient solution for utilisation of cash balances between trades on stock exchanges. This is only the second liquid fund ETF available in the market. Reliance ETF Liquid Bees is the other one, started in 2003 under Benchmark Asset Management.

The addition of this latest scheme to the liquid fund category, where most of the schemes are in the open-ended mutual fund format, helps broaden access via the exchanges. However, liquid funds have many other uses for investors.

Here is a quick look at why adding a liquid fund to your portfolio can be beneficial.

WHY DO YOU NEED A LIQUID FUND?

First let us understand what it is. A liquid fund is a basket of debt and money-market securities managed with the objective of providing low risk regular returns. This is achieved by investing in securities that mature within 91 days. Low maturity makes the returns relatively stable. For securities maturing within 60 days, the fund must accrue or add interest daily, thereby eliminating the marked-to-market risk or risk of price change. For securities maturing between 60-91 days, there is impact of price change too along with the accrued interest. Price of debt securities move up when yield falls and vice versa. However, given the low remaining maturity, the impact of price change is limited. Currently, in most liquid funds, majority of securities have a maturity of 30-50 days.

These characteristics of liquid funds make them an ideal investment for emergency money that you need to keep safe, and accessible. Their open-ended structure lets you access the money at any time. If you choose to withdraw your money today, the amount will be in your account by tomorrow. Plus you earn daily return.

Deepali Sen, certified financial planner and founder, Srujan Financial Advisers LLP said, "For an emergency fund...I recommend at least 50% of the amount be invested in a liquid fund where money is safe and accessible." Many fund houses also offer instant redemption facility with their liquid funds, up to Rs50,000 or 90% of the fund value, whichever is lower.

Other than investing your idle cash and contingency money gainfully, you can also use liquid funds for staggering investments into, say equity. If you want to invest in equity markets in sporadic tranches rather than a fixed-period systematic investment plan (SIP), money in a liquid funds is useful as it can be transferred out easily. Of course, you could also have a fixed systematic transfer (STP) from your liquid fund into an equity fund within the same fund house.

According to Kunal Bajaj, founder and chief executive officer, Clearfunds.com, "On our platform, broadly investors who are buying liquid funds understand the product and use it more for convenience. They often pick the liquid fund of a fund house where they eventually want to switch into an equity fund." The advantage is that you earn returns daily, which are on average better than the average 3.5-4% from your savings back account. Note that these returns are taxed.

Also note that there is a rare chance that liquid funds can deliver negative returns. This can happen if the portfolio quality is poor and there is a default in payment for a security held in the portfolio, or if there is a large systemic liquidity event that impacts returns across funds. According to Sen, "One has to stick to the known performers with good-quality portfolios and a pedigreed fund house. Rare, but it has happened, and clients should be aware of that small probability."

HOW TO CHOOSE A LIQUID FUND

You have to keep track of four basic factors: return consistency, expense ratio, minimum investment allowed and portfolio quality. If the need is stability, a liquid fund with widely fluctuating returns is not desirable. Also, you don't want a fund with high expense ratio to eat into your daily returns. The range in expense ratios for liquid funds is between 5 and 100 basis points per annum, with the average being around 25 basis points. One basis point is one hundredth of a percentage point.

"The narrow dispersion of returns in among liquid funds makes it harder for an algorithm to pick one over the other. If a liquid fund has a high return and high expense ratio, one has to question whether return comes at the cost of safety. Ideally, one should look for lower expense ratio, lower risk. Here, size is not the enemy of performance. In fact, a large sized and dominant fund house is often the right home for your liquid funds," says Bajaj.

Some liquid funds allow a minimum investment of Rs500 and others may be Rs10,000. You need to choose the one that suits you.

Also, there is a difference in picking an ETF versus a regular fund. The former needs you to have a demat account and you need to be mindful about tradability of ETF units for the amounts that you want to buy or sell on the exchange.

Other than buying liquid ETFs from stock exchanges, you can invest in liquid funds directly on the mutual fund house websites, on online direct investment platforms and distributor platforms or through your adviser.

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How to choose a liquid fund

Basic factors to keep in mind are: consistency of returns, expense ratio, and minimum investment allowed

	Average rolling returns annualised (%)			AUM (Rs cr)	Expense ratio (%)		Min. investment (Rs)
Scheme	1-month	3-month	1-year		Regular	Direct	
Aditya Birla Sun Life Cash Plus	7.90	7.99	8.40	34,691	0.17	0.09	1,000
ICICI Prudential Liquid	7.86	7.95	8.36	32,481	0.17	0.10	500
Reliance Liquid-Treasury Plan	7.86	7.95	8.36	29,173	0.17	0.09	100
HDFC Liquid	7.83	7.91	8.32	27,433	0.21	0.11	5,000
SBI Premier Liquid	7.80	7.88	8.30	26,525	0.16	0.10	50,000
Axis Liquid	7.86	7.94	8.35	25,159	0.08	0.04	500
UTI Liquid Cash Fund-Inst.	7.82	7.90	8.31	21,812	0.05	0.02	500
Kotak Floater Short Term Reg.	7.90	7.98	8.40	18,275	0.09	0.04	5,000
UTI Money Market MF-Inst.	7.85	7.94	8.35	17,417	0.15	0.04	10,000
DSP BlackRock Liquidity-Reg.	7.81	7.90	8.30	16,443	0.14	0.04	1,000
Category average	**7.61**	**7.69**	**8.11**		**0.24**	**0.10**	

Top ten funds based on AUM; Inst: Institutional; Reg: Regular; Rolling returns taken for the last 5 years

Source: Valueresearchonline