

## Meet the Manager

# 'Defining concentration risk based on ratings will help investors'

Mutual funds may finance less of wholesale assets in future, says CIO, Reliance MF

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Given the recent incidents around IL&FS and DHFL, concentration of portfolio will have to be looked at more closely at the time of investment, especially in the case of high-yield products. One way to provide a better picture of the risk profile of a fund to retail investors will be to define concentration risk itself based on ratings, and map overall ratings of bonds in the portfolio to long-term ratings, says Amit Tripathi, CIO - Fixed Income Investments, Reliance Mutual Fund. Excerpts from an interview with *BusinessLine*.

**With the RBI cutting rates in its previous policy, there are expectations of more rate cuts if inflation trends continue to remain sanguine. What is your view on interest-rate movements?**

There are two levels to look at the argument of rate cuts. One, if we consider the interest-rate construct from a basic data perspective, inflation trends in the recent past suggest that there is some degree of permanency in the low inflation

trend. However, given the disparity between core and headline inflation and the overall uncertainty over food inflation, the quantum of permanency of low inflation is unclear. In this scenario, we expect another 25-50 bps of rate cut by the RBI this year. Also, the RBI will be proactive in providing more liquidity, mainly through OMOs (open-market operations), as the focus is on boosting growth.

However, at the second level, transmission of rate cuts and fiscal position are key issues that need watching. On the fiscal defi-

cit front, there hasn't been consolidation on a combined Centre and State basis over the past two years. We are also seeing some capital expenditure move off-balance sheet (internal and extra budgetary resources). Hence, this implies that there will continue to be pressure on government bonds on the supply side, despite the RBI's OMOs. Also, from a long-term perspective, the sustainability of low inflation also comes under question when the fiscal does not get the due attention.

As far as transmission goes, in the past two years, most of the transmission has happened through the capital market route. This is because weak balance-sheets of banks limited the transmission of lower cost of funds to lending rates. Now, there are challenges in the capital market, as funding companies

in certain sectors is becoming increasingly difficult. Hence, while transmission at the bank level may improve, in the capital market, there could be some issues, which means that, net-net, there will be transmission issues even in the current fiscal year.

So, overall, looking at all these factors — the RBI's action, fiscal deficit and transmission — while the RBI may ease rates, how much impact it would have on the yield curve and on bringing down cost of funds for corporates in the near term is unclear. We do not see any sharp movements in the current fiscal on the bond yields. Hence, assessing the direction of interest rates in the next 24-36 months seems easier rather than in the next 6-12 months.

**What about foreign investors? According to the latest data, FPIs are utilising just about half their limit for government bonds. Will foreign flows into Indian bond**

**markets continue to remain tepid?**

For foreign investors, more than rates, stability of domestic currency matters. Foreign investors are increasing their flows to emerging markets, but these flows continue to elude Indian markets. While uncertainty over general elections is keeping the rupee on tenterhooks and foreign investors on the sidelines, if the rupee stabilises post-elections, I expect flows to increase.

**In recent months, the IL&FS crisis and concerns over DHFL (recent downgrade) have impacted debt funds — more so in smaller funds where the AUMs have shrunk and the concentration risk has spiked. How should one look at credit risk in debt funds, going ahead?**

The DHFL issue has been a peculiar case of a AAA rated bond facing stress. Much of the increase in some funds' concentration in these bonds has been due to sharp fall in AUMs. The DHFL issue impacts debt funds in two ways — valuation and liquidity.

From a valuation perspective, most of the DHFL papers in funds' portfolios are reasonably valued. So I don't see much issue on the valuation part. But on the liquidity front, not only DHFL, but bonds of

other NBFCs have also seen poor liquidity.

Hence, it has not been a credit risk issue as much as drying up of liquidity in the recent months. Also, any asset on which a debt has been raised and which does not have the capability of paying itself through cash flows is under scrutiny — it has not got much to do with the quality of the underlying asset. Going forward, such assets will need to be financed by more patient capital — private equity, long-term AIFs (Alternate Investment Funds), etc.

That said, from a mutual fund perspective, from now on, concentration will have to be looked at more closely, at the time of investment, especially in the case of high-yield products. Also, mutual funds may fund less of wholesale assets in future.

**So, as a fund house, how have you managed credit risk, given that ratings by credit rating agencies have come under a lot of scrutiny?**

We have always been in the business of predicting ratings and not following ratings. So ratings is a comment on the present state of affairs of any balance-sheet. If, as a fund house, I'm lending money to a corporate for a two to three-year period, I'm taking a futuristic view

on how the company's balance-sheet will shape up in the next five years or so.

So we place a lot of importance of research — out of our 18-member team in debt, 10 are from credit research. And, given the recent incidents around IL&FS and others, our focus will continue to be on building the research team and expertise. As the market becomes more complex, the need for credit research increases. Importantly, a fund house has to have sizeable presence to undertake quality research.

**Do you think that the SEBI should mandate more disclosure in debt funds for retail investors that gives more colour on the risk profile of the fund?**

One way to provide a better picture to retail investors will be to define concentration risk itself based on ratings.

For instance, if AAA rated bonds concentration is capped at 10 per cent, AA rated bonds concentration should not be more than 5 per cent, and so on. Also, it would help if the overall ratings of bonds in the portfolio are mapped to long-term ratings (since short-term bonds are mostly rated highest). Long-term rating will give investors a reasonable idea of the credit risk of the fund.



*So overall, looking at all these factors — the RBI's action, fiscal deficit and transmission — while the RBI may ease rates, how much impact it would have on the yield curve and on bringing down cost of funds for corporates in the near term is unclear*

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