# Franklin Templeton Mutual Fund - Winding Up Credit Funds

## Why in news?

Franklin Templeton Mutual Fund (MF) in India recently made a decision to wind up six yield-oriented managed credit funds.

## How does a mutual fund work?

- Mutual Fund (MF) is an investment vehicle made up of a pool of moneys collected from public investors.
- The pooled money is used to buy other securities by professional money managers (fund house).
- It gives small or individual investors access to professionally managed portfolios of equities, bonds and other securities.

## What does winding up of the schemes mean?

- Winding up of the schemes essentially means that the MF will first liquidate the assets in the schemes.
- It will then return the money to investors.
- The six schemes have combined assets under management of around Rs 28,000 crore.
- This is nearly 25% of the total assets under management of Franklin Templeton MF in India.

## Why was the decision now?

- The fund house said the decision was to protect value for investors via a managed sale of the portfolio.
- This comes amid the severe market dislocation and illiquidity caused by the COVID-19 pandemic.
- Reportedly, the ongoing liquidity crisis in the market has impacted higher yielding, lower-rated credit securities in India.
- Since these six schemes had direct exposure to them, they have been impacted.
- [**Higher-rated bonds** of companies are more secure and offer lower interest

rates.
- On the other hand, credit risk funds generally invest in **lower-rated bonds** that offer higher return but also carry a higher risk.]

## What led to this condition?

- Credit risk funds are debt funds that play on the principle of high-risk-high-reward.
- The managers of most credit risk funds have been seen chasing high yields and ignoring the associated higher risk.
- This worked well when the external environment was good, with high economic growth rate and no undue pressures on the liquidity front.
- However, when there is stress in the economy, even strong companies find it tough to raise funds.
- So naturally, companies with a weaker balance sheet and higher leverage are most vulnerable to chances of default.
- At such a time, banks, mutual funds and financial institutions that have lending exposure to such companies will see stress building.
- Also, borrowers will not be able to service the interest and principal payment.
- The COVID-19 pandemic and the lockdown resulted in a combination of these factors.

## What are the implications?

- With the market situation tough for now, investors may not get an immediate exit.
- The fund house may find it difficult to get a buyer for the low-rated assets in the portfolio.
- In effect, the investors may have to wait.
- If at all the fund house pushes hard to get new buyers for those assets, it will go at a substantial haircut.
- This would mean a big loss for investors on their capital investment.
- In essence, investors will have to pay a heavy price for the incompetence of the fund house.

## What caution should investors take now?

- The fund house has said that all other funds it manages - equity, debt and hybrid - are unaffected by the decision.
- So, the winding up of the six schemes will have a limited impact on investors of other schemes.
- However, as the economy is facing a serious challenge, investors should look

at the quality of the companies where their investments lie.

- If their investments have exposure to lower-rated companies that are highly leveraged, they must consider reallocating them.
- The Association of Mutual Funds in India has assured investors of the healthy credit and liquidity profiles of investments.
- Despite all, shutting down six schemes is unprecedented and can break investor confidence in mutual funds.

## How important is the role of the fund manager?

- Franklin Templeton Mutual Fund is the 9th largest in the country.
- Investors are now questioning why only Franklin Templeton was unable to anticipate the unfavourable developments.
- Generally, all credit risk funds invest up to 65% in bonds rated AA or below.
- However, market experts say that fund managers can lower their risk by following a higher diversification strategy.
- On significant diversification on the asset side (not given large exposure to a few companies), the entire portfolio will not be affected even if there is a default by one or two companies.
- Similarly, on significant diversification on the liability side (not having just a few large investors), fund houses may not have to sell even if one or two investors seek redemption.

## What should the policy support be?

- The results of the latest round of the RBI's targeted long-term repo operations suggest that banks are unwilling to take on credit risk.
- So, the RBI should fill this vacuum in taking credit risk.
- It should consider providing direct liquidity to intermediaries, similar to what was done during the financial crisis of 2008-09.
- The costs of intervening early are less than the price of delayed action.

**Source: Indian Express**