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Side-Pocket Method of Mutual Funds

Why in news?

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Mutual funds are taking up the idea of creating a 'side pocket' for the doubtful asset, to handle financial pressures.

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How Indian mutual funds handles economic pressures?

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- The recent case of the IL&FS group defaulting on debt obligations has highly impacted Indian mutual funds. Click here to know more about IL&FS default.
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- Mutual funds are taking up the idea of creating a 'side pocket' for the doubtful asset, after such episodes.
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- A 'side pocket' is a way to segregate quality debt instruments in a debt portfolio, from those that have defaulted on interest or repayments, or are faced with a rating downgrade because of deteriorating financials.
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- So, a fund house carves out the bad bonds from its main portfolio into a 'side pocket'.
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- In the IL&FS case, over two dozen schemes had exposure to bonds from IL&FS or its group entities.
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- After the downgrade, some schemes decided to treat their entire holding as doubtful, and write it down fully, resulting in a cut of 6-8 per cent in

their NAV, which can shake investor confidence.
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How a side-pocket method works?

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- The fund’s NAV will then reflect the value of the good assets, with a separate NAV assigned to the side-pocket assets based on the estimated realizable value for investors.
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- If the doubtful asset is finally sold, the value is credited to unit holders who own the side pocket.
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- There are rules governing the valuation write-down that a fund must take when in the case of downgrades or default, and this is typically done in phases, depending on the date of default and NPA recognition norms.
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- The proceeds from the side pocket unit sales will be credited to the investors in the fund when the ratings downgrade happened.
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- The side pocket also ensures that only investors who were in the fund at the time of the write off, will get the benefit of any future recovery from the bond.
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- New investors who buy units after the write-down do not get to make windfall gains.
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What is the significance of the side-pocket method?

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- Creating a side pocket insulates the rest of the debt funds’ portfolio from such rotten apples.
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- Typically, when there is news of a default or a ratings downgrade, investors in open end funds may panic and pull out money.
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- As sentiment worsens, there can be a rush from all categories of investors to redeem units.

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- When faced with redemption requests, a fund house that holds an illiquid downgraded security can be forced to sell its quality holdings in order to meet the redemption pressure.
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- Also, investors who do not wish to cash out or are ignorant of the developments would be left back in the fund, facing severe erosion in their NAV.
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Source: Business Line

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