

Liquidity with Quality

Investors find cash management funds especially appealing when they look for higher-than-average returns, safety and liquidity all at one stop. Badrish Kulhalli, portfolio manager of the Principal Cash Management Fund, explains how this offering blends the tenets of safety of principal with the management team's three-layer research process.

What is a Cash Management Fund and who invests in these funds?

Cash Management funds, also called as Money market Funds or Liquid Funds, are fixed income funds investing at the very short end of the yield curve to almost eliminate the interest rate risk in these funds.

Cash management funds are popular with investors who are looking for investment returns that are better than the rates available from banks for short term investment. These investors look for safety of principal along with better yields and liquidity for their short term investments.

The positioning of the Cash funds enables the Fund Manager to generate returns that are significantly better than what an average savings bank account or a current account in a bank can give the investors.

The risk in these funds is very low. Due to the very low duration of the papers in the fund, the interest rate risk is negligible. Secondly, the portfolio construction process emphasizes liquidity of the investment through a combination of maturity buckets and laddering of maturities. Hence, Liquidity risk is minimized. Thirdly, by choosing to invest only in the highest credit grade securities, the credit risk in the fund is also very low.

Hence, an investor gets a combination of very low risk, low volatility and relatively higher returns in a cash fund. Being an open-ended fund, investors have complete flexibility in choosing the time of investment and redemption from the funds, at the daily

NAV. Cash funds are popular with investors looking for low risk investments as well as investors with short term cash surplus.

What is your research process?

Research methodology for analyzing the corporate credits is a three step process.

We first analyze the financial health of the company from its latest published numbers. They are compared with past performance as well as with peer companies operating in the same industry and environment. Secondly, we also discuss the company's financial with the relevant rating agency to understand their rationale for the rating assigned to the company's borrowing. Then we also talk to the company management to understand their liquidity and debt management process and their future plans which are likely to affect their cash flows. A key part of our analysis is to understand, if the company has a short-term debt or any other maturities up for repayment or rollover, and the rates that they are likely to get in the market.

If companies are raising resources in the short term debt market while they arrange long term loans for business expansion, then the company may be exposed to higher rates or tighter credit markets. The risk is that the company may be forced to roll over the short term debt for a while at unfavorable rates or may find itself unable to raise fresh debt and may affect the company's cash flows and their ability to repay debt on time.

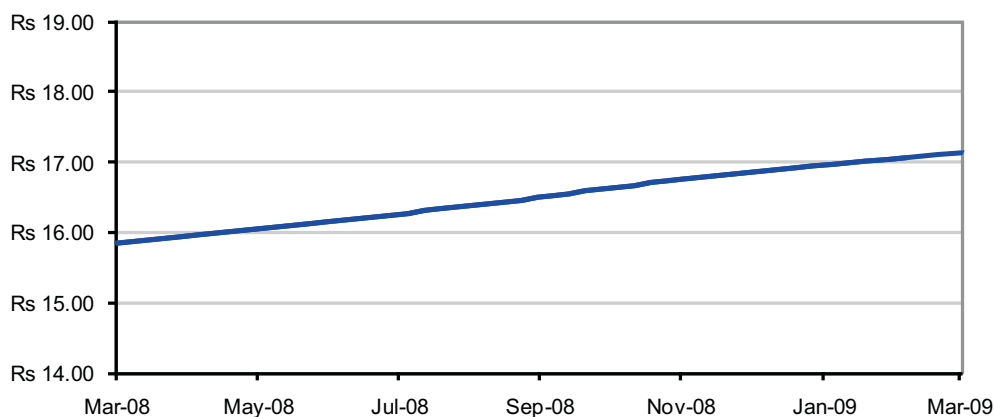


Mr Badrish Kulhalli has ten years of experience in the Fixed Income markets, in Sales, Trading and Fund Management, which also includes a stint in managing Fund-of-Funds.

Badrish has a B.E (Mech) degree from the University of Poona and a PGDM from IIM Calcutta. Prior to joining Principal PNB AMC, he was working with Optimix Division of ING Investment Management.

“In a cash fund, liquidity of investments is the primary concern. We do not compromise liquidity requirements to get higher returns.”

Principal Cash Management Fund (PCMF) Price History NAV (3/31/08 - 3/31/09)



Post these three steps, the credit analyst proposes the setting up of a credit limit for the company and sends the proposal to the Head Analyst for the sector at Principal Financial Group in the US. The India credit analyst has to address all the concerns of the Head Analyst and if the Head Analyst is satisfied with the credit, he / she approves the credit proposal. After this approval, the credit committee in India, deliberates on the credit proposal and approves or rejects the setting up of the proposed limits.

All limits set up for a company have to be reviewed annually or earlier in case of any credit event.

What is your portfolio construction process?

In a cash fund, liquidity of investments is the primary concern. We do not compromise on liquidity parameters to get higher returns.

Fund flows are very volatile. So we aim to maintain a prudent proportion of cash or near cash instruments in the portfolio. The second source of liquidity is the maturity of investments, where we follow a laddering structure with an increase in the amount of maturities for specific periods, where we expect higher liquidity requirements. We do see some amount of seasonality in liquidity flows, with quarter ends being key periods of volatility.

We aim to maintain at least 60% of the portfolio in very liquid Money market instruments like CDs or CPs. The cash

and near cash proportion depends on the expectations for the liquidity flows in the market in the near months. We may at times maintain, not more than 10% of the portfolio in relatively illiquid but higher yielding structured assets, to give a slight boost to the returns.

Once the broad allocations are worked out, we look to invest in specific issues that qualify for the Liquidity, Credit and Duration requirements of the fund.

How many instruments do you generally have in the fund?

We generally have about 30 to 60 instruments in the fund. However, there may be multiple instruments from a single issuer. There is no limit on the number of bonds from a single issuer as long as it meets quality criteria. We have a single issuer limit of 7% of the portfolio. That is a stringent limit compared to the limits prescribed by SEBI at 15%. Due to the lower limit per issuer, we have at least 18 – 20 different issuers in our portfolio and consequently a relatively higher number of instruments in our portfolio.

Most funds have limits on the exposure to the size of each issue and issuer. What are your considerations?

We are indifferent to the size of a particular issue as long as it fits our liquidity, credit and duration criteria. We do find ourselves in situations, sometimes, where we subscribe to an entire issue. We have, as mentioned earlier, a single issuer limit of 7% of portfolio. This limit helps us in

diversifying the credit exposure in the fund.

Who are the largest issuers of money market debts and can you give us an example of an issuer?

The largest issuers are banks and they use this market for its speed and efficiency to gather liabilities. Almost all banks are active issuers of CDs.

But a good example of a credit from the financial companies in the private sector, is Sundaram Finance Ltd. They finance commercial vehicle purchases and have been in business for the last few decades. They use very conservative business practices and do not run large asset liability mismatches. As a result the duration difference between their liabilities and assets is low. They have very strong franchise across south and western regions of India. Their ability to make collections on their loans even in times of stress or slowdown is very good and has been tested in previous slowdowns as well. If we look at their liability profile, long-term bonds around two or three years are their primary source of funding. The second source is short-term borrowing, more like six months to one year and the balance is bank borrowing. The bulk of their funding is from short-term bonds, one to three-year bonds that are specifically issued in maturities that match their assets. Bank finance is used as a backstop for short-term cash needs. The company typically ensures that sufficient liquidity is maintained in the form of undrawn bank lines to cover its short term maturities within the next 30 days, on a rolling basis.

How are Commercial Papers different from the short-term bonds?

Some companies prefer to issue short-term bonds or non-convertible debentures over CPs due to their relative ease of issuance and costs involved. We are indifferent whether the company issues a CP, a short-term NCD / Bond. The key consideration for us is that we cannot invest in an instrument that is

longer than three months maturity in the Cash fund.

What are the default rates in CDs or CPs that you invest in?

Defaults are very minimal because the markets are purely high investment-grade markets. There is almost no acceptance of papers rated lower in the investment grade categories and none whatsoever in the below investment grade categories. We are talking of only the most creditworthy companies finding buyers for their paper in this market. Over the last 8 or 10 years, I do not recall more than a handful of defaults.

Are loan receivables securitized in India?

We do have a loan securitization market in India. However, the activity and new issues have slowed down considerably over the last two years. Commercial Vehicle and passenger car loans backed securitized papers are the most common issuances. There were a few personal loan receivables that were securitized, but have not seen any paper backed by credit card receivables.

Currently we do not hold any securitised pools in our portfolios. We are concerned about the quality of the underlying loans and feel that pricing is not appropriate to reflect this risk.

The other part of the securitized market that is still active are the Single Loan backed PTCs. These papers are backed by loans made to a single large corporate. The analysis of the credit risk on these papers is along the lines of the usual credit analysis for corporate bonds.

Are these a part of the money market instruments?

No, they are not money market instruments, as defined by RBI.

However, the Cash Fund can invest in securitized papers that have a final maturity upto 3 months. These papers are extremely illiquid and do not trade in the secondary market. Hence they are

held to maturity.

How is your fund different from 24 other money market funds?

The key differentiator of our fund is the sharp focus we maintain on risk management. Cash Funds, by their very positioning and structure, are exposed to high cash flow volatility. Hence the prime risk that is managed is the Liquidity risk in the portfolio, which is addressed by a combination of laddering of maturities as well as holding a large proportion of very liquid papers. The credit risk in the portfolio is minimal due to or emphasis on investing only in the highest credit rated papers. Interest rate risk is minimal due to the very nature of the fund. Hence, in a competitive landscape of numerous funds in this category, we position our fund in the low risk category. This low risk positioning ensures that the return volatility is low and investors can hope to get steady returns on their investment. **ii**

Principal Cash Management Fund (PCMF)

Fund Facts		
Website	www.principalindia.com	
Address	Exchange Plaza, 2nd Floor, B Wing, NSE Building, Bandra Kurla Complex, Bandra (E), Mumbai - 400051	
Tel. No.	+91 22 6772 0555	
PCMF Inception Date	Regular (Oct 25, 2000), Insti (May 9, 2003), Insti Premium (Aug 30, 2004)	
Portfolio		
Total Net Assets	Rs. 2,020.51 crores	
Category	Open Ended Liquid Scheme	
Asset Allocation		
CPs / CDs	67.78%	
Floating Rate Notes / Bonds	8.44%	
NCD / Deep Discount Bonds	4.50%	
Treasury Bills	3.51%	
Sovereign	0.25%	
Cash & Other Assets	15.52%	
Modified Duration (Days)	42.58	
Effective Avg Maturity (Days)	43	
Investment Information		
New Investment	Open	
Min Initial Investment		
Regular Plan	Rs. 5 000	
Institutional Plan	Rs 1.00 crore	
Institutional Premium Plan	Rs 10 crores	
Min Subsequent Investment		
Regular Plan	Rs 1000	
Institutional Plan	Rs. 1 lakh	
Institutional Premium Plan	Rs 1 lakh	
Returns – Regular Plan (Growth) vs. Benchmark Index ¹		
	PCMF	Index
Last 7 Days	0.08%	0.06%
Last 15 Days	0.17%	0.12%
Last 30 Days	0.35%	0.33%
Last 3 Months	1.26%	1.71%
Last 6 Months	3.05%	4.13%
1 Year	7.59 %	8.64%
3 Year	7.43 %	7.54 %
5 Year	6.49 %	6.43 %
Since Inception	6.55 %	N.A
Returns – Institutional Plan (Growth) vs. Benchmark Index ¹		
	PCMF	Index
Last 7 Days	0.08%	0.06%
Last 15 Days	0.18%	0.12%
Last 30 Days	0.37%	0.33%
Last 3 Months	1.32%	1.71%
Last 6 Months	3.16%	4.13%
1 Year	7.82 %	8.64%
3 Year	7.64 %	7.54 %
5 Year	6.71 %	6.43 %
Since Inception	6.40 %	6.02 %
Returns – Institutional Premium Plan (Growth) vs. Benchmark IX ¹		
	PCMF	Index
Last 7 Days	0.09%	0.06%
Last 15 Days	0.19%	0.12%
Last 30 Days	0.38%	0.33%
Last 3 Months	1.39%	1.71%
Last 6 Months	3.35%	4.13%
1 Year	8.24 %	8.64%
3 Year	7.96 %	7.54 %
Since Inception	7.11 %	6.57 %
Fees and Expenses		
Entry Load	Nil	
Exit Load	Nil	
Plan Options		
Regular Plan	Growth, Daily Dividend, Weekly Dividend and Monthly Dividend.	
Institutional Plan	Growth, Daily Dividend, Weekly Dividend And Monthly Dividend.	
Instit. Premium Plan	Growth, Daily Dividend, Weekly Dividend And Monthly Dividend.	
Portfolio Manager		
Badrish Kulhalli	February 2009	
¹ CRISIL Liquid Fund Index		
Unit conversion : 1 lakh = 100,000 , 1 crore = 10 million		
Source: Company Documents		

About Ticker Q&A

Our research staff analyzes and selects funds based on their consistency in performance and durability of investment style.

Each Q&A article covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. These interviews uncover strategies and techniques that help to generate long-term investment goals.

You can find more fund profiles and view our other publications on Ticker.com and 123jump.com