Think Long Term, Think LIQUID FUNDS!

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Given the rapid downgrades and subsequent defaults in a few bonds in the recent past, most mutual fund investors have turned cautious about the underlying credit quality of the investments. While it is easier to ascertain the credit quality of schemes in a long maturity bond portfolio, it is a little difficult to arrive at the true credit quality of short-term papers, having lower than 1-year maturity. Most of the short-term papers tend to get a rating of A1+, the highest short-term rating - irrespective of differences in their longer-term ratings. Hence, it is important for the discerning investor to dig a little deeper to correctly ascertain the credit quality in their liquid, ultra-short, low duration and money market mutual fund schemes as well.

There are two scales used by rating agencies in general – a 20-point scale ranging from AAA to D for bonds with maturities greater than 1 year and a 9-point scale ranging from A1+ to D for instruments with maturities of less than 365 days. One is not implying that credit risk is inherently avoidable, but simply stating that relying on short term ratings as A1+ ratings could give the wrong impression about safety /credit quality. The short-term rating scale does not map one to one with the long-term rating scale and does a relatively poor job in differentiating credits of varying degrees of safety on the longer scale. An investor would probably accept a portfolio of issuers if shown only the short-term ratings of A1+ but turn away if shown the corresponding lower long-term ratings of say AA-.

Long Term Rating	Short Term Ratings		
	Corporates	NBFCs	Banks
AAA	A1+	A1+	A1+
AA+	A1+	A1+	A1+
AA	A1+	A1+	A1+
AA-	**A1+**	A1+	A1+
A+	A1	**A1+**	A1+
A	A1	A1	A1+
A-	A2+	A1	**A1+**

Source: CRISIL's criteria for rating short term debt – Nov 2019

The highest short-term rating of A1+ gives the impression that it is equivalent to the highest long-term rating as well. Not always true. It would be surprising to know that a company with a relatively low long-term rating of AA- would easily achieve the highest short-term rating of A1+. In fact, a bank with a rating of A- on the long-term rating scale, 7 notches below AAA, could get a rating of A1+ in the short rating scale, as it has access to funding lines from the RBI against its holding of SLR bonds. What we perceive to be the safest in the short run is not being rated high on the long-term rating scale by the rating agencies. This leads to a wrong perception that all A1+ ratings are equally safe.

A credit rating indicates the current opinion of a rating agency on an issuer's ability and willingness to pay interest and principal on time. In a way, ratings differentiate between companies/issuers of debt in the same currency by classifying them in differing brackets of relative creditworthiness. When an investor invests in a bond or a fund, it interprets a higher rating as a safer investment option compared to a lower rating on the same scale.

We believe that to be safe and truly liquid, a short maturity fund like the Liquid Fund should consider not only the short-term ratings but also the long-term factors that affect the company.

One counterargument could be that Liquid Funds are extremely short term in nature as the underlying portfolio consists of instruments that mature within 91 days and one tends to have greater visibility in the short term. Agreed, except that one bad apple spoils the pie and it is worth spending the extra effort to ensure the safety of the entire portfolio.

The business environment is challenging. Business and market cycles are getting crunched. In these times, it would be prudent to look at the long-term creditworthiness of your short-term portfolio as well.

Our approach is thus to take the least amount of risk, by investing in papers that carry the highest rating across all time periods. Higher-quality papers tend to be more liquid as well implying less impact cost. Liquidity is defined as the ability to exit an investment, without significant loss of value.

Even when you invest short term, it is prudent to think long term.