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Performance of Mutual Fund due to Credit Rating Downgrade

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ABSTRACT

Mutual fund is an investment mechanism, which collects money from investors and invests in diversified area. This is good vehicle for regular investor who doesn't have more knowledge about investment. Objective of this paper is how mutual funds get affected due to downgrade of credit rating. As mutual fund contains diversified portfolio so change in rating of any one company effect whole fund. Mutual fund is rated on the basis of performance of Net Assets Value, Portfolio turnover, risk and return as well as various expenses like Sharpe ratio, Beta ratio etc. Due to downgrade in credit rating NAV decreases, hence fund become risky and interest rate rise. This study provides evidence on the relationship between performance of mutual fund and credit rating. Any change in rating impact the fund. In this paper I explained about the factors that make Credit rating downgrade. As Rating tells about the creditworthiness of the borrower, if borrower having low rating means they are not able to pay principle and interest amount on time. Research methodology I used for this Paper is qualitative research.

Introduction

Mutual fund is an investment vehicles, it pulls money from the investors and invest in bonds, stocks, money market instrument and other types of securities. Investing in mutual fund is like taking a slice of bread from bread pocket. The owner of the mutual fund receive proportional share of gains, losses, income and expenses. Investment of funds depends on the object of mutual fund like, Objective - i) Equity growth: - need to invest in stock, ii) Debt income: - need to invest in fixed income securities, iii) Money market: - need to invest in short term money market instrument, iv) balanced: - need partial investment in stock, partial in fixed income securities to maintained the balance between return and risk. Most of the assets management company offer open ended mutual fund

scheme, where investor any time buy and sell the fund. Mutual fund investment attract investors because of, i) professional money management, ii) Affordability, iii) Liquidity, iv) Diversification, v) convenience vi) flexibility and vii) variability. Credit rating is an opinion on credit worthiness of entity and the level of credit risk associated. It is a symbolic representation provided by credit rating agencies (CRAs) like, CRISIL, ICRA, CARE etc.

For mutual fund credit rating gives separate rating to all the funds of an assets management company (AMA). As the fund contain diversified portfolio, so the rating of individual fund which is included in mutual fund are considered. Upgrading and downgrading of credit rating of individual portfolio of mutual affect the whole mutual fund performance. The key reason of credit rating downgrade is because of their deteriorating finance, usually high debt and NPA (non-performing assets). Always looking the key ratios such as incremental Return on Capital Employed (RoCE), Return on Assets (RoA) for investment decision but not taking any initiative to recover the dues may leads to credit rating downgrade. Not only NPA also the high debt-to-equity ratio leads to downgrade. Debt -to-equity ratio shows the ability of firm to serve its debt. Below is

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the list of banks with high NPA. If mutual fund manager invest in these kinds of banks may receive low rating.

Table-1: Banks with High NPA and Ratio to Bank’s Total Assets

Name of Bank	NPA (in Cr.)	Ratio	Name of Bank	NPA (in Cr.)	Ratio
IDBI	25,206	13.21%	Union Bank	18,832	6.57%
PNB	32,702	7.81 %	Canara Bank	21,649	6.33%
Bank of India	25,305	7.9 %	Bank of Baroda	18,080	4.72%

If the company having high debt-to-equity ratio means low ability to serve debt but the company having high Interest Coverage ratio means higher ability to pay debt. Below is the list of high debt-to-equity ratio firm and Poor ICR firm.

Credit rating downgrade effect the ability of company to borrow money. Leaders hesitate to give loan to the company whose debt rating is downgraded. It impacts the future plan of the company and decrease the image of the company in market and investors mind. Usually the rating downgrade is immediately followed by a fall in stock price, which impact equity investment in short run. And due to this mutual fund investment adversely impacted. Mutual fund is combination of diversified stock, bond and securities of different company. Due to credit rating downgrade of one debt of a company, affect whole mutual fund performance. The CRAs provide rating to the mutual fund by analysing the all companies debt contained by fund, their ratings and past 5 year performance of mutual fund. Low rating contains high risk and high interest rate. Downgrade in rating leads the company to loss because they require offering high interest rate; hence cost of borrowing is increased and directly impacts the finance of company.

This paper explains the reasons of credit rating downgrade of mutual fund. Some funds are got high rating initially but after some time is may got downgraded or upgraded. This paper will discuss about the impact of credit rating downgrade on performance of mutual fund. How it got affected by rating downgrade.

Literature Review

Previous studies on mutual fund tell us about how mutual fund is organised, what are the factors that impact mutual fund, how tax return effect mutual fund inflow. C. Hoff Stauffer, Jr. and Robert C. Vogel explain the parameters of mutual fund in their paper. They examine the performance of mutual fund through ex-ante and ex-post problem. Data taken for studies is from Wiesenberger with a sample size of 82 open end investment company. Period of data is 1955-64. Return on each mutual fund is measured by mean of Wiesenberger index and risk is measured by standard deviation of annual rate of return. They use regression equation to check the risk return factors.

Through the analysis they found that there is positive relationship exist between risk and return, risk and return combination of mutual fund reflect their investment objective, expenses ratio and turnover ratio of mutual fund is unrelated to performance of mutual fund and mutual fund performance is highly associated with loading charges.

Daniel Bergstressera and James Poterba is their studies examine the relationship between the after tax-return and subsequent cash flow of equity mutual fund. For this study they took large sample of retail equity mutual funds over periods of 1993-1999. This is done in United States. This research evaluates the impact of personal taxation on the returns earned by mutual fund investors. After the analysis of different ratios of equity mutual fund they suggest that the individual income tax burden that fund investors face when they hold a fund is negatively correlated with fund inflows. “Mutual funds that offer higher after-tax rates of return attract greater inflows than those with lower after-tax returns, even after we control for a fund’s pretax return. The inflow effects associated with changes in income tax burdens or capital gains overhang are comparable in magnitude to the effects of fund expense ratios on inflows”. They find that taxation play a role while choosing mutual fund. To save the tax investor invests in mutual fund.

In the above both research paper they discuss about the how mutual fund performance got affected. What are the parameters of mutual funds? They discuss about many factors but not about credit rating of mutual fund. This paper will discuss about the affect of credit rating downgrade on mutual fund performance.

Research Design

Data Source

Data taken for this study is from morning star and CRAs rating reports.

Analysis

Our research paper is based on qualitative research as well quantitative research. Data is analysed by using correlation statistical tool. While assigning rating to the mutual fund of AMC, CRAs different methodology to find out the risk associated with the fund. Negative credit rating outlook is indication of downgrade of rating. In debt fund rating factors that are considered is credit quality of individual assets, diversification of portfolio, management quality and operational policies. The credit rating is given by CRAs like CRISIL, CARE, ICRA etc. The rating agencies want to determine the chance of default of Mutual Fund scheme. That assessment is made to check either scheme is able to repay the interest and principal or not. High credit rating indicates that the scheme is able to pay interest and principal on time. Opposite to it, poor rating indicate adverse situation. That suggest scheme might become default on repayment of interest and principal. For rating, primary factor considered is timely payment from investment the scheme has made. Any missed payment or default makes the rating downgrade or lower rating. A positive

outlook leads to increase in rating by CRAs. Negative outlook like decrease in cash flow leads to credit rating downgrade.

Below is the latest rating symbol of mutual fund by CRISIL

Long- term scale

Short-

term scale

Rating Symbol	Meaning	Rating Symbol	Meaning
CRISIL AAAmfs	Highest safety	CRISIL A1mfs	Highest safety
CRISIL AA mfs	High safety	CRISIL A2mfs	Strong safety
CRISIL Amfs	Adequate safety	CRISIL A3mfs	Moderate safety

CRISIL BBBmfs	Moderate safety	CRISIL A4mfs	Least degree of safety
CRISIL BBmfs	Moderate risk		
CRISIL BBmfs	High risk		
CRISIL Cmfs	Very high risk level		

CRISIL provide rating according to the level of safety of scheme of mutual fund. A mutual fund rating is usually a measure of a fund's historical risk-adjusted performance over different time frames compared with the funds in the same category. It is thus a composite measure of both return and risk, which gives an idea about its ability to deliver returns for a given level of risk.

Table 2, below is the list of top mutual fund performer for 1year. Fund is selected on random basis from top performer list of Morningstar.

Name	Morningstar Risk (Rel to Category)	3 Yr. Volatility	YTD Return %	1 Yr. Anlstd %	3 Yr. Anlstd %	5 Yr. Anlstd %
SBI Small & Midcap Fund Direct Plan Dividend Payout	Above Average	16.79	1.31	71.95	30.00	38.75
HDFC Small Cap Fund-Direct Growth Option	Average	16.09	1.55	57.78	22.81	25.04
L&T Emerging Business Fund Direct Dividend Payout	Above Average	17.89	0.80	57.67	26.73	-
L&T Emerging Business Fund Direct Growth	High	17.89	0.80	57.67	26.75	-
Reliance Small Cap Fund - Direct Plan - Growth Plan	High	18.56	1.44	56.18	25.08	36.75
HDFC Small Cap Fund Dividend Payout	Below Average	16.07	1.47	55.92	21.30	23.91
IDFC Sterling Equity Fund-Direct Plan-Dividend Payout	Average	16.56	0.98	53.58	17.59	22.16
BOI AXA Tax Advantage Fund-Direct Plan- Growth	Above Average	14.31	1.50	53.35	17.71	21.92
L&T Infrastructure Fund Direct Plan Growth Option	Above Average	18.19	0.81	51.83	23.07	24.50
IDFC Sterling Equity Fund - Regular Plan - Growth	Below Average	16.47	0.90	51.72	16.88	21.54
L&T Infrastructure Fund Dividend Reinvestment	High	18.14	0.79	50.39	22.08	23.57
Mirae Asset Great Consumer - Direct Plan Growth	-	13.43	1.97	49.42	18.24	21.88

The scheme which is highly rated is combination of fund which is either AAA rated or AA rated. Downgrading of an individual fund affect the performance of scheme because return on particular fund is decreased and risk is increased. Above risk level provided by Morningstar after analysing the stock market, equity, ETF research and rating. The outperformance is measured by Jensen's Alpha by taking last 3 year data. It shows the relationship between risk and return by MF scheme relative to expected market return predicted by CAPM (Capital Assets Pricing Model). Higher the Alpha means performance of portfolio has outstripped the returns predicted by market.

Average returns generated by the MF Scheme =

[Risk Free Rate + Beta of the MF Scheme * {(Average return of the index - Risk Free Rate)}

From the study of CRISIL default and rating simulation 2016 it is found that from 1988-2016, 93.8% rating are stayed constant to CRISILAA for 1 year. 1.5% upgraded to AAA and 5.2% downgraded to A and below.

Conclusion

Not only the funds of scheme's rating effect the rating of scheme but also the rating of country effect the performance of mutual fund scheme. As the change in rating of country impact the share market. If the rating of country is upgraded, it is good for long term mutual fund scheme. From the study we found that the rating downgrade of Fund is directly related to the NVA

of Company and fund rating downgrade directly impact the mutual fund. Hence there is a positive correlation between NAV and performance of MF. If the MF contains the fund of a company whose rating is got downgraded means it will decrease the performance of scheme. Similarly if another fund got upgraded then performance will increase. Performance of MF is based on rating of fund's it contain and fund's company financial strength. If the MF got downgraded the investor demand more return on investment. It increases the cost of borrowing for scheme.

Rating downgrade of a MF makes the company to pay more yields that leads to fall in price. Suppose if MF is downgraded from AAA to AA then investor want same return the bond rated AA are offering. When Rating is downgraded, investor marked it as a market loss and Investor don't want to hold that scheme for a long time. Not only rating impact the bond price also "Changes in global interest rates, domestic liquidity, monetary policy actions, fiscal situation of a country among other factors also impact interest rates". Highly rated MF indicates that scheme is able to pay interest and principal on time.

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