INVESTING

Check for liquidity while selecting MF, PMS and AIF products: Harshad Patwardhan of Girik Capital

By Pravin Palande May 9, 2023, 12:28 AM IST

Harshad Patwardhan, CIO, Girik Capital. image credit: Girik Capital

Synopsis

"Liquidity is like a vital body parameter that most people tend to ignore until something goes wrong," says Harshad Patwardhan, chief investment officer of Girik Capital. In an emailed interview with ET Prime, he discusses the challenges and importance of maintaining a liquid portfolio, especially in small and mid-cap funds.

It is often said that the job of a fund manager is more about managing risks than delivering returns. The best fund managers are those who take moderate risks and at the same time deliver high returns. But this takes time, and the risk comes in different forms — through fundamentals of a stock or can be macro in nature where interest rates or inflation play a prominent role.

Then, there is the liquidity risk. This risk is true for companies where there is a lack of buyers or sellers on a given day. Small and mid-cap companies are many times illiquid, and when the market crashes, it becomes difficult to sell these stocks, especially when funds are facing redemption.

To manage this risk, fund managers either maintain a high position in large-cap stocks or in cash. But most of them do it by maintaining a diversified portfolio and low concentrated risk which also depend on the size of the fund — bigger the size, higher are the number of stocks in the portfolio.

One of the largest small cap funds with total asset under management (AUM) above INR 20000 crore has 168 stocks in its portfolio. Its largest investment is 3.4% and the lowest is 0.07%. The average weight of a stock is at around 0.6%. The fund manager is not taking any concentrated risk to avoid the liquidity issue in case the market becomes volatile and exiting a position becomes difficult. It is also for this reason that the fund maintains 9.63% of its position in large-cap stocks and 35% in mid-caps, according to Value Research, a mutual fund-dedicated website.

The second-largest fund with a size of INR15,000 crore invests in 53 companies. Here the average weight of a stock is 1.62%. The fund manager is taking some levels of concentrated risk but then the bulk of companies are mid-caps. The fund has a large cash position at 4.5% of the total AUM.

These are the funds that have given high returns over longer periods in a category that is risky and highly volatile. According to Morningstar data, over the last five years, small-cap funds have returned 13% annually as compared to large cap funds' 10.9% returns.

Harshad Patwardhan, chief investment officer of Girik Capital, a Sebi-registered **PMS** firm, gives a practical explainer on the topic of portfolio liquidity where he talks about the challenges and importance of maintaining a liquid portfolio, especially in small- and mid-cap funds.

In his words, "Liquidity is like a vital body parameter that most people tend to ignore until something goes wrong. Unfortunately, by the time investors and advisors realise its importance, the damage is already inflicted."

On this note, he shares why the liquidity measure should be an integral part of a checklist used to select mutual fund, PMS and **AIF** products. Below are the edited excerpts of an emailed interview.

What is liquidity in portfolio context?
In the financial services industry, liquidity means different things to different people in different contexts. In this note, we use the word liquidity (in the context of investment products such as mutual fund, PMS or AIF) to refer to the ability of a fund manager to meet redemptions in an orderly manner without compromising the interest of investors who are not redeeming.

What happens if the liquidity is overlooked?
One common cause of accidents in the investment management industry is a

mismatch between available liquidity for investors of a pooled-fund product and underlying liquidity of an asset-class segment.

This mismatch typically arises when capacity constraints of a strategy are overlooked. Over time, the fund becomes too big with respect to the underlying asset-class segment, leading to pockets of illiquidity.

Just as people tend to take their health for granted in good times, many investors and advisors take liquidity of a product as a given. The trouble starts when circumstances turn adverse, often due to exogenous shocks.

Moreover, typically, poorer the quality of an individual security, higher is the shrinkage in its liquidity. Naturally, it gets difficult to find buyers for such a security in bad times. Inevitably, 'bid ask spread' widens. If the percentage of such poorer-quality illiquid securities is high, the portfolio performance starts to deteriorate. At this stage, smarter investors, who sense trouble, rush for redemption.

To meet these redemptions, the fund manager is forced to sell what he can (better-quality liquid securities) and not what he ideally wants to (poorer-quality illiquid securities). In this process, interests of investors who do not redeem are severely compromised, as the overall quality and liquidity of the portfolio worsens rapidly. This typically affects the portfolio performance even further. Sometimes, the outcome for investors is even worse in terms of restricted redemptions.

How should fund managers think of liquidity?

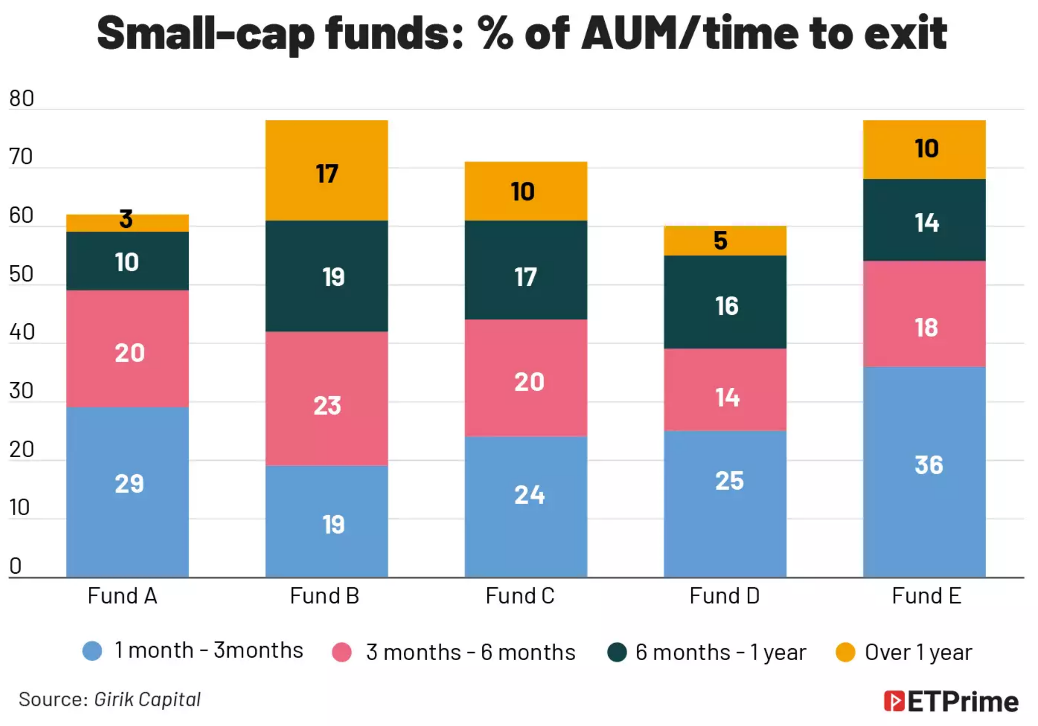
In the investment process, fund managers should factor in liquidity at the design stage itself and not as an afterthought. So, while sizing individual bets, a close attention to this aspect is needed. It is important to balance performance with liquidity in the long-term interests of all investors. It is also important to monitor fund liquidity regularly as the underlying market liquidity keeps changing depending on circumstances.

Not only should one keep an eye on the overall liquidity of the portfolio but also on that of individual stocks. The objective is not to be forced to change the complexion of the portfolio while meeting redemptions.

How to measure portfolio liquidity?

Portfolio liquidity can be expressed in terms of how many days it will take to convert equity holdings to cash to meet redemptions. For this computation, one should consider market liquidity of individual stocks on a rolling average basis (to factor in changes in underlying liquidity) and impact cost by limiting orders to a percentage of total volume traded. Liquidity can be easily computed using publicly available data and can be used as a relative measure to compare funds. This concept is extremely relevant for all pooled small-cap and mid-cap mandates. It is also useful to evaluate multi-cap, 'large and mid-cap' mandates where fund sizes are large.

What are the pockets of illiquidity in small-cap mutual funds?
To elaborate on the concept of liquidity, we examine March 2023-end portfolios of a few of the leading small-cap mutual funds. We analyse liquidity at the individual stock level to assess how long it will take the fund manager to sell it in the market. For this computation, we take the average three-month trailing traded volume of that stock and participation rate of 25% of traded volume. This analysis yields how many days it will take for each of the stocks in the portfolio to be liquidated. Below is the result of this analysis for five leading funds in the small-cap category.



We have clubbed the portfolio stocks in different buckets to reflect the proportion of AUM that can be converted into cash in different time periods. So, for fund B, it will take longer than a year to sell stocks worth 17% of the AUM of the fund! Also, for this fund it will take longer than six months to sell stocks worth 36% (17%+19%).

Investors and advisors should make their own assumptions (as per their comfort) for the average trailing traded volume of a stock and participation rate.

However, it is important to note that the average daily traded volume of individual stocks tends to change depending on the state of the market and prospects of the individual companies. The purpose of this analysis is to demonstrate the extent of illiquidity in pooled funds and how the composition of the portfolio could change if faced with large redemptions.

What measures will you ask investors to add to their checklist?
Most investors and advisors use past-performance track record, brand, and perceived portfolio quality as some of the key factors to shortlist and select funds. We strongly advocate that liquidity measures should also be an integral part of

this checklist. It is true that liquidity becomes critical in tough times and may not matter much when times are good. But then, isn't it better to do a regular health check-up for prevention than having to rush to a hospital in an emergency?

(*Graphic by Sadhana Saxena*)

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