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Quid Pro Quo

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Cash Cows; Spoilt Milk!

Despite tremendous interest in mutual funds worldwide, mutual funds did not manage to catch the fancy of Pakistani investors until recently. Since then the Pakistani mutual funds industry is growing at an unprecedented rate as reflected by the rising number of new asset management companies. The level of competency has also increased with new research companies and large banking institutions entering the asset management business.

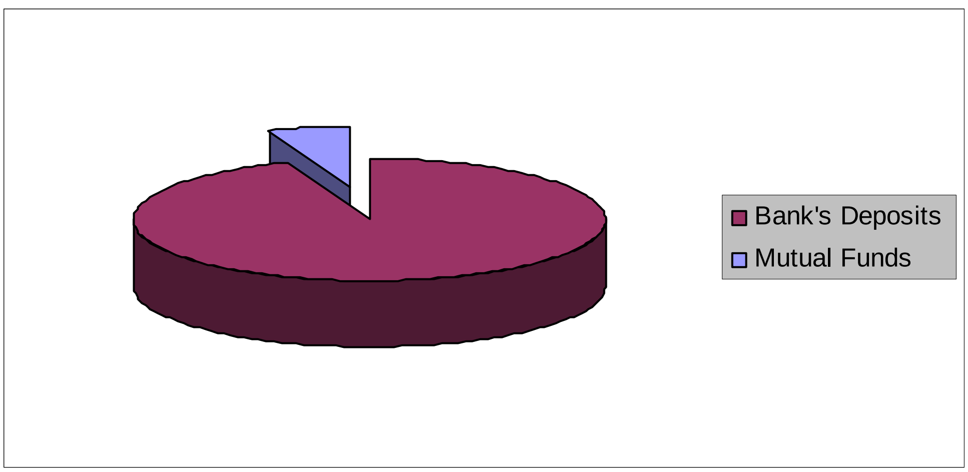
This report will examine in detail the underlying principle of mutual funds and the different types of funds that exist to offer investment opportunities to its investors. It will primarily concentrate on cash funds, highlighting the risks and rewards associated with these funds, before evaluating the future viability of asset management companies.

An Emerging Industry

The Pakistani economy has witnessed phenomenal growth in the recent past in all segments of the economy namely agriculture, industrial and services sector. This growth is strongly reflected in the returns of the economy's capital markets that are additionally supported by the dynamic economic and investment policies executed by the Government of Pakistan. These proactive policies have boosted the investor sentiment both internally and externally, as the economy witnessed increased local and international interest in its assets as well as in its capital markets. Today the Pakistani capital markets are one of the best performing markets among the emerging countries around the globe and are expected to continue their growth momentum in the near future.

Within the developing capital markets, a relatively new industry that has come under the limelight is the mutual funds industry. Though the origin of this industry dates back to the 60's, the private Asset Management industry is relatively new in Pakistan. The first open-end mutual fund was introduced in 1962 with the public offering of National Investment (Unit) Trust. This was followed by the establishment of the Investment Corporation of Pakistan in 1966, which subsequently offered a series of closed-end mutual funds. Despite tremendous interest in mutual funds worldwide, mutual funds did not manage to catch the fancy of Pakistani investors until recently. The investments with the Mutual Funds stand at approximately PKR 176 billion, less than 6% of the total deposits of the domestic banks that as of Feb 2007 are recorded at PKR 3.034 trillion. Though this reflects a significant increase from the previous ratios, it is rather a small number when compared to the neighboring economy of India. In India investments in mutual funds stand at 15% of the banking sector deposits while in the United States the mutual funds have 150% more deposits than banks. This essentially means that the mutual funds industry of Pakistan has a huge growth potential.

Figure 1: Mutual Funds/Banks Deposits



The industry has already grabbed considerable attention from the investors, and is growing at an unprecedented rate as reflected by the rising number of new asset management companies and the increased interest of individual and corporate investors to exercise investment options through professional expertise. The level of competency has also increased with new research companies and large banking institutions entering the asset management business.

Mutual Funds: An Introduction

A mutual fund is defined as a collection of stocks or/and bonds. The principle idea behind a mutual fund is that individual investors generally lack the time, the inclination or the skills to manage their own investments and therefore depend on professional managers to manage the investments for the benefit of their investors in return for a management fee. Each investor owns shares, which represent a portion of the holdings of the fund. The organization managing the investment is the Asset Management Company.

Globally mutual funds have gained increased importance as vehicles for investment for both individuals and institutions. Mutual funds generally provide several benefits to their investors. First, they reduce the risk of investing in any single market by diversification. By owning shares in a mutual fund instead of owning individual stocks or bonds, the risk of the investor is diluted. Second, investors can acquire economies of scale. Since a mutual fund buys and sells large amounts of securities at a time, its transaction costs are lower than what an individual would pay for securities transactions. Thirdly a primary advantage of mutual funds is the professional management of the investor’s money. A mutual fund is a relatively inexpensive way for a small investor to get a full-time manager to make and monitor investments.

While all benefits of mutual funds stated above have generally been accepted as real benefits, the benefit of having access to financial expertise has been questioned extensively in finance literature. Nevertheless, the variety of investment opportunities available through these funds offers several benefits to the respective investors.

The types of mutual funds available vary according to the fund’s investment objective which usually seek capital gains (gains made from the sale of portfolio securities) and income (income earned from dividends on stocks and interest on bonds) or a combination of both. At the fundamental level, mutual funds can be classified into three categories: Equity funds (stocks), Fixed Income funds (bonds) and Money Market funds. All mutual funds are variations of these three asset classes. For example, while equity funds that invest in fast-growing companies are known as growth funds, equity funds that invest only in companies of the same sector or region are known as specialty funds. The investors can also hold balanced funds that entail investment in a combination of fixed income and equities.

Equity Funds: Funds that invest in stocks represent the largest category of mutual funds. Generally, the investment objective of this class of funds is long-term capital growth with some income. There are, however, many different types of equity funds as there exist several types of equities.

Fixed Income Funds: They denote funds that invest primarily in government and corporate debt with the primary objective of providing a steady cash flow to investors. They are especially popular amongst conservative investors. Bond funds are likely to pay higher returns than certificates of deposits and money market investments, but bond funds carry relatively high risk. Because there are many different types of bonds, bond funds can vary dramatically depending on where they invest.

Money Market Funds: A money market fund seeks safety of principal by investing in high quality, short-term securities, for example: T Bills. This type of fund is designed with the aim that an investor's principal should not decrease in value. There is no guarantee, however, that this will always be the case. A money market fund seeks to provide a regular distribution of income which is determined by short-term interest rates.

The Domestic Scene

In Pakistan and the rest of the developed/developing world, investment in equity funds represents the largest category of mutual funds. This is largely because extraordinary gains can be made off these investments. These funds however constitute a significantly high risk which is highlighted considerably by the media and therefore are popular only amongst risk takers. On the other hand for risk-averse investors, the popular choice in Pakistan are cash funds, a term used generally to denote fixed income/money market funds in Pakistan, as very low risk investments.

As explained earlier, cash funds tend to preserve capital and invest in short-term, high quality debt instruments. Since the objective of investment in these funds is short-term income and stability, the risk of losing principal is argued to be minimal. These funds therefore represent the most prudent investment choice for an investor who prioritizes liquidity, capital preservation and periodic income on his/her investment portfolio. Cash funds can be invested in a wide variety of bonds (corporate, municipal and government debt obligations or a combination of three) than most individuals can afford separately. In this fashion these funds can help to generate current income while diversifying a portfolio. Moreover, being liquid in nature these funds provide an additional advantage to its investors. Asset management companies are increasingly marketing cash funds amongst the low risk investors arguing that these generate low-risk, higher (compared to merely holding deposits in Banks) and tax-free returns. In addition to this some companies provide guarantee to the investors about the protection of the principal amount of money in case of any unanticipated crisis. In this manner the asset management companies have an advantage over the banking sector where banks do not provide tax-free return on fixed deposits

As a result increased investment is seen in cash funds and subsequently many analysts today foresee mutual funds competing with banks and taking lead in raising fixed deposits in the near future, acquiring maximum share in the financial market. While it is true that cash funds help to counteract stock market fluctuations besides offering other benefits outlined above, the risks associated with these cash funds are often understated.

Quantity & Quality: Much Needed!

The risks associated with the cash funds, can be traced to the underdeveloped debt markets of the Pakistani economy; particularly the corporate debt market. Pakistan’s corporate debt remains below 1% of GDP with Term Finance Certificates (TFCs) being the most popular instrument. This leaves government instruments as the major driver of financial assets in the economy, and therefore most trade takes place in these instruments alone.

The most common government debt instruments available are T Bills and PIBs. Over the last few months, the yields for the government’s PIBs have shown an increase and the ten year PIB yield is at approximately 10.1-10.15% which is much higher as compared to yield on one year T Bill. With cut throat competition in the mutual funds industry, cash funds are under immense pressure to provide incremental return to their investors. This pressure to enhance their return has made mutual funds shift their focus to the higher yielding long term PIBs. However this increased investment in PIBs presents a huge risk to the investors both in terms of a duration mismatch and interest rate risk.

The duration mismatch exists because investors may park their money in cash funds with a short term perspective. This essentially means that the liabilities of the mutual fund have a small duration. On the other hand the fund managers generate a higher return by investing in the longer duration PIBs; in this way a duration mismatch is introduced between their assets and liabilities.

What must be noted is that this mismatch may not pose a significant challenge in a mature debt market; however in our domestic market this is a significant risk factor as history tells us that liquidity for PIBs may change unpredictably. Take for instance an investor who approaches a fund manager, wanting to invest in cash funds while demanding a return of at least 10%. After evaluating the level of risks and returns desired by the investor, the fund manger parks the investors’ money in a ten year PIB. However the investor can redeem his/her investment at demand at any point in time. If for instance the investor demands redemption at a time of adverse liquidity conditions, the asset manager may not be able to unload the PIBs into the market, at least at favorable prices.

Although asset managers keep significant liquid investments for redemptions, in case of a run on the asset fund (for various reasons) it is not impossible that the PIBs may have to be sold.

Investing in PIBs also exposes the mutual funds to interest rate risks as in case of interest rates hikes, the price of the PIB will fall much more significantly as compared to that of T Bills due to its longer duration and the investors will suffer substantial capital losses. Moreover increase in interest rates are often associated with reduced M2 growth, which may mean that rising interest rates may lead to both mutual fund redemptions and liquidity gaps in the PIB secondary markets which would result in both duration and interest rate risks coming into play at the same time.

In light of this one may argue then that T Bills present the safest investment in mutual funds. However due to low returns of such investments often fail to outpace inflation by a far enough margin to meet an investor’s financial goals.

TFCs, a long term corporate debt instrument, provide a good alternative to government securities because a majority of these instruments in Pakistan are floating in nature. So investing in these instruments would denote a very low interest rate risk for the mutual funds. Although investing in TFCs would create credit risks for the mutual funds, it could be argued that investing in TFCs of blue chip companies with proper diversification, this risk would be minimal. But the main problem is that the market for TFCs is still very small and their market is very illiquid which reduces the liquidity of the asset portfolio drastically. In addition, there is a dearth of good quality issues, leaving the cash rich mutual fund industry with PIBs as their only viable option for yield enhancement.

A Bleak Future for a Bright Present?

The future outlook of the mutual funds industry, particularly the cash funds although very promising, faces significant hurdles. The growth in the number of asset management companies has not been matched by a parallel growth in the asset markets. So even though in the current economic scenario the industry holds several exciting opportunities for both corporate and individual investors with specific needs (retirees), the risks in terms of rigid competition among mutual funds and limited investment avenues should not be overlooked.

In the recent years the Securities and Exchange Commission of Pakistan (SECP), has taken a number of substantial steps to promote the development of mutual funds industry. These measures include impending multifaceted reforms to help the industry in managing its risks prudently, grant of operational autonomy, and protection of investors’ interest. Comprehensive disclosure requirements at the time of public offering and subsequent reporting on the affairs of funds have been prescribed and enforced.

Nevertheless, considering the shortcomings of the cash funds particularly, there need to be developed new asset classes with additional efforts from SECP and the private mutual fund industry. There is already news regarding introduction of new assets through the Real Estate Investment Trust. This will help in expanding the asset base while attracting a much larger number of investors towards the emerging capital market through the mutual fund industry.

Economic Snapshot

Fiscal year 06-07														
	Units	April	May	June	July	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April
Inflation														
Headline Inflation	%	6.16	7.12	7.65	7.63	8.93	8.73	8.11	8.07	8.88	6.64	7.39	7.67	6.9
Core inflation	%	6.43	6.58	6.29	6.28	6.20	6.16	5.70	5.62	5.5	5.3	5.72	5.42	5.2
Food inflation	%	3.64	5.59	7.78	7.44	11.08	11.26	10.54	10.62	12.71	8.7	9.99	10.74	9.4
Non-food inflation	%	8.01	8.21	7.55	7.77	7.43	6.98	6.41	6.27	6.22	5.2	5.59	5.54	5.2
T-bill (Wgt Avg)														
3 month	%	8.10	8.10	8.29	8.32	8.63	8.64	8.64	8.65	8.64	8.64	8.64	8.65	8.69
6 month	%	8.29	8.29	8.45	8.49	8.81	8.81	8.81	8.81	8.81	8.81	8.81	8.82	8.9
12 month	%	8.79	8.79	8.79	8.79	9.00	9.00	9.00	9.00	9.00	9.00	9.01	9.01	9.08
External Sector														
Export	Mln US$	1,450	1,527	1,533	1334	1392	1392	1288	1448	1536	1227	1421	1536	n.a
Import	Mln US$	1,656	2,330	2,685	2383	2267	2172	2162	2139	2365	2100	2103	2070	n.a
Trade balance	Mln US$	(206)	(803)	(1152)	(1049)	(875)	(780)	(874)	(691)	(829)	(873)	(682)	(534)	n.a
Remittances	Mln US$	401	507	464	376	435	422	410	448	475	391	457	520	n.a
Forex Reserves	Mln US$	13,021	13,003	13,137	12,725	12,631	12,512	12,503	12,460	12,960	13,212	13,378	13,624	13,661

n.a = Not Available

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