Investment Analysis of Fixed Maturity Plans in India

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Abstract

Investment Management is a science of application of idle funds to available alternative investment avenues in specific allocation. This allocation is decided on the basis of many factors such as investment objective, capacity of funds, risk profile of the investor etc. The investment analysis of several available solutions like corporate securities, mutual funds, debentures, government securities, depository receipts, banking instruments etc is done on the principle of so called “Opportunistic Balancing of Free Cash Flows”. This technique helps in understanding the importance of various investment modes and amount to be invested according to risk-return attitude of the investor. One of such investment option is called Fixed Maturity Plans, which are essentially close ended funds and might hold reasonable investment potential in the near future.

The current article studies the availability of Fixed Maturity Plans as a source of investment to retail and institutional investors altogether. This article studies various facets of FMPs and risks associated with them. Investment in Fixed Maturity Plans was under great criticism during year 2008, when global financial crisis lead to a loss of huge sums of money to fund houses due to investment in this option. The real estate sector and NBFC were the worst to get hit by crisis scenario by FMP investment. This phenomenon was noticeably traced due to deleveraging of personal disposable income quotient of retail investors. With the help of this article we will try to analyze the current investment opportunity and benefits offered by some products in the Indian capital market.
1. Introduction

1.1 Meaning
Fixed maturity plans, or FMPs as they are popularly called, are close-ended funds with a fixed tenure and invest in a portfolio of debt products whose maturity coincides with the maturity of the product. Fixed maturity plans (FMP) floated by mutual funds requires a thorough due diligence process on the part of the investor before committing any money to the plans. They are closed-ended funds, which mean that an investor can invest in them only when they are open for purchase. This is only during NFO (New Fund Offer) period. To redeem the investment, the investor needs to wait for the plan to mature or pay exit load. Being close ended funds, fixed maturity plans offer flexibility to their fund managers and let them plan on their exact investments even at the IPO stage. This helps the investors to know in advance the yields that they can earn at IPO stage approximately.

1.2 Investment Features
A fixed maturity plan generates stable income or capital appreciation by investing in a wide range of debt and money market instruments. Investments are made in a portfolio of securities with a maturity profile similar to the plan. It generally invests in certificate of deposits, commercial papers and corporate debentures. Credit rating of the instruments depends on the objective and strategy of the fund but generally investments are made primarily in AAA rated papers. It is safe to assume low credit risk. FMP’s have no equity component unless you invest in a FMP that chooses to have a limited equity option.

1.3 Investment Objectives
The objective of such a scheme is to generate steady returns over a fixed-maturity period and immunizing the investor against market fluctuations. FMPs are typically passively managed fixed-income schemes with the fund manager locking into investments with maturities corresponding with the maturity of the plan. The objective is to lock into a certain rate of return on the assets at inception, thereby protecting the schemes against market fluctuations. Unless specified in the objective of a FMP, investments are in risk-free or highly-rated assets for principal protection. FMPs with equity component will be more dynamically managed as fund managers cannot invest in equities for locking in to inception returns.

2. Investment Cost-Benefit Analysis of Fixed Maturity Plans

2.1 Key Factors Influencing Investment Decision in Fixed Maturity Plans
The following are the key factors which an investor must look at before investing in FMPs:

- Cash flow forecasting: FMPs are suitable for investors who require locking in funds for a particular period of time. E.g. If an individual has a certain disposable cash outflow in four years time, investing in a debt FMP with four
year maturity can be considered as the investor is only concerned with receiving the principal plus return on the investment at the end of four years.

- **Immunization of investments**: FMPs are a good investment vehicle for investors who are targeting a return on their investments over a fixed period of time and are indifferent to market volatility within that period.

- **Interest rates currently prevailing in the market**: The investor should look at interest rates on government bonds, corporate bonds, commercial papers, certificate of deposits, securitized assets, bank deposits, company deposits and other short to medium term fixed income products before taking an investment decision in a FMP. This exercise will give an idea to the investor on the return one can expect on FMPs. The investor can then use this knowledge to lock into returns through FMPs or directly through other fixed income products.

- **Kinks in the yield curve**: The yield curve sometimes exhibit varying forms against the normal upward sloping nature of the curve. In cases where the yield curve is inverted with short term rates higher than long term rates, investors can look for opportunities to capture the deviation through FMP's. This type of investment planning helps in studying a technique called “**term shift investment**” in personal finance.

- **View on the equity market**: FMPs are generally meant for investors who are indifferent to market fluctuations in the short term. However it pays to form a view on the markets for investing in FMPs with equity components as equities markets carry a higher risk in the short term than in the long term.

### 2.2 Risk Analysis of Investment in Fixed Maturity Plans

Despite their claims of being one of the safest investment options around, FMPs do have their own share of risks. This has been evident in year 2008, when these funds faced liquidity crisis due to their exposure to real estate and finance companies. When the finance and realty companies landed in trouble during the recent economic downturn, their offerings also lost value. With the investors pulling out their investments from these FMPs, the funds were forced to offload their investments in the illiquid markets, thereby causing liquidity crisis. While FMPs offer safety of their capital, they do not offer protection against interest rate risk. As the interest rate rises, the value of the bonds goes down. This can affect the returns of the fund. The yields of FMPs are just representative. The actual yield will depend on the yield on the debt instruments at the time of actually investing your money.

The following are the major type of risks inherent in Fixed Maturity Plans:

- **Credit risk**: The credit portfolio in the plan can suffer in case of downgrades by rating agencies. Downgrades bring down the price of the securities as investors demand a higher risk premium on the asset leading to higher credit spreads. If the fund manager is forced to liquidate the security as it crosses a threshold rating levels, the scheme will suffer capital loss. Debt securities are thus subject to the risk of an issuer’s inability to meet principal and interest payments on the obligations.
• Market risk: Market risk in an FMP is high where there is an equity component in the plan. The fixed maturity nature of the FMP, forces the fund manager to take shorter term calls on equities. This can lead to trading losses as the fund manager does not have the luxury of time to hold on to the investments. While it is the intent of the Investment Manager to invest primarily in highly rated debt securities, the Schemes may from time to time invest in higher yielding, lower rated securities. This would enhance the degree of risk.

• Regulatory Risk: Other risks may include local tax laws considerations, international and regional political and economic developments, possible imposition of exchange controls or other local governmental laws or restriction and the possibility of limited legal recourse for the fund.

• Risk of Unlisted Securities: The Schemes may invest in securities which are not quoted on a stock exchange. Unlisted securities may lack a liquid secondary market, and there can be no assurance that the Schemes will realize its investments in unlisted securities at a fair market value, if sold in the secondary market.

• Transactional Performance Risk: The corporate debt market is relatively illiquid as compared to the government securities market. Even though the government securities market is more liquid compared to that of other debt instruments, on occasions, there could be difficulties in transacting in the market due to extreme volatility or unusual constriction in market volumes or on occasions when an unusually large transaction has to be put through. Trading volumes, settlement periods and transfer procedures may restrict the liquidity of these investments.

• Risk of Asset Mismatch: If the fund manager is unable to find assets exactly maturing with the plan, this leads to a risk of asset liability mismatch. This risk can nullify the immunization of the investment.

• Terms for large investors: Investors will have to watch out for terms on large investors i.e., if large investors are given zero or low exit loads. This can lead to early exit by large investors from the plan. This will affect the returns on the plan substantially. This category of investors is called “influencers” in fund terminology.

• Interest rate Risk: FMPs are designed to immunize investor against interest rate risk. However, as a plan is launched and money is collected, interest rates can fall before the money is invested and the funds will have to be invested at a lower rate. The non availability of a forward rate market in India is a chief contributor to interest rate risk in a FMP. As with all debt securities, changes in interest rates may affect the Net Asset Value as the prices of securities generally increase as interest rates decline and generally decrease as interest rates rise. Prices of long-term securities generally fluctuate more in response to interest rate changes than the short-term securities. The Debt markets can be volatile leading to the possibility of price movements up or down in fixed income securities and thus the possible movements in the NAV.
• **Settlement Risk:** The inability of the plan to make intended securities purchases due to settlement problems could cause the plan to miss certain investment opportunities. By the same rationale, the inability to sell securities held in the plan’s portfolio due to the extraneous factors that may impact liquidity would result at times, in potential losses to the plan, in case of a subsequent decline in the value of securities held in the plan’s portfolio.

• **Risk of Zero Coupon Instruments:** The market prices of zero coupon securities are generally more volatile than the market prices of securities that pay interest periodically and are likely to respond to changes in interest rates to a greater degree than other coupon bearing securities having similar maturities and credit quality. The credit risk factors pertaining to lower rated securities also apply to lower rated, zero coupons or deferred interest bonds. Such bonds carry an additional risk, unlike bonds that pay interest throughout the period to maturity, the Schemes would not realize any cash until interest payment on the bonds commence. If the issuer defaults, the Schemes may not obtain any return on its investment.

• **Prepayment Risk:** Certain fixed income securities give an issuer the right to call back its securities before their maturity date, in periods of declining interest rates. The possibility of such prepayment may force the fund to reinvest the proceeds of such investments in securities offering lower yields, resulting in lower interest income for the fund.

• **Reinvestment Risk:** This risk refers to the interest rate levels at which cash flows received from the securities in the Plans are reinvested. The additional income from reinvestment is the “interest on interest” component. The risk is that the rate at which interim cash flows can be reinvested may be lower than that originally assumed.

### 2.3 Advantages of Investment in Fixed Maturity Plans
The following are the key benefits of parking funds in FMPs:

• **Capital protection:** FMPs have less risk of capital loss than equity funds due to their investment in debt and money market instruments.

• **Low interest rate sensitivity:** As the securities are held till maturity, FMPs are not affected by interest rate volatility. The actual returns are more or less close to the indicative returns declared at the scheme’s launch.

• **Interest rates currently prevailing in the market:** The investor should look at interest rates on government bonds, corporate bonds, commercial papers, certificate of deposits, securitized assets, bank deposits, company deposits and other short to medium term fixed income products before taking an investment decision in a FMP. This exercise will give an idea to the investor on the return one can expect on FMPs. The investor can then use this knowledge to lock into returns through FMPs or directly through other fixed income products.

• **Lower cost:** FMPs involve minimum expenditure on fund management, as there is no requirement for a time-to-time review by fund managers to buy/sell
the instruments constituting the fund. Since these instruments are held till maturity, there is a cost saving in respect of buying and selling of instruments. As such, there is relatively lesser charge of brokerage and fund related expenses.

- **Tax benefits**: FMPs score over fixed deposits because of their tax efficiencies both in the short-term as well in the long-term.
- **Minimum Investment**: The minimum investment amount is usually Rs 5,000, which a retail investor can easily invest.

### 2.4 Recommendations for usage of FMP as an investment vehicle:

The following are the key benefits of parking funds in FMPs:

- Check out the indicative portfolio of the fund. If you observe the presence of any securities that are not AAA rated, don’t invest.
- Don’t depend on the indicative yield as the actual return. There may be a big variance between the yield shown by the fund house at the time of investment and the actual yield.
- Always stick to the maturity period of the plan. Don’t withdraw half way through as it will force the fund manager to redeem investments at any available price, thereby causing losses to you as well as other investors.
- Watch out for the Fixed Maturity Plans between January and March every year. That’s when it offers double-indexation benefit. Indexation helps reducing long term capital gains thereby reducing overall tax liability.

### 3. Conclusion

The Rebirth of Fixed Maturity Plans in 2010 – A bag full of opportunities

After the debacle in FMP mutual funds in 2008, fixed maturity plans had been shunned by high individuals (HNIs), retail and institutional investors in India. Fixed Maturity Plans almost led to the dismantling of the entire Indian mutual fund system, as FMP MF managers invested in risky assets such as Real Estate Company fixed deposits. The RBI stepped in to clean up the investment crisis with key regulations along with SEBI. Fixed Maturity Plans, however, have risen like a Phoenix from the ashes during 2009-2010 with investments in new Mutual Fund FMP IPOs of almost 6000 crore. Some key developments regarding FMP investment are:

- New Fixed Maturity Plans (FMP new fund offers) have been launched by ICICI Prudential Mutual Fund, HDFC Mutual Fund, Fortis Investments, JM Financial and Tata Mutual Fund.
- New FMP MF NFOs will probably offer lower return than the fixed maturity plans offered by mutual funds last year, but there is really no estimated return. However, the recent SEBI regulations regarding FMP Mutual Funds have ensured that the investments in fixed maturity plans are more secure. With SEBI’s new reforms, there are strict restrictions and disclosures needed from MFs in India launching Fixed Maturity Plan (FMP) new fund offers (NFOs).
The quality of investments by Fixed Maturity Plan (FMP) mutual funds has also improved, as the new FMP IPOs of 2009 have desisted from investments in risky assets such as real estate company fixed deposits and NBFC investments. RBI and SEBI had ensured that Fixed Maturity Plans in India could not be sold before maturity and that FMPs could be freely tradable in the market. However, given the low trades for bonds in the Indian market, FMPs or Fixed Maturity Plans are hardly traded, giving FMPs very low liquidity. However, HNIs or High Net worth Individuals still continue to believe in Fixed Maturity Plans as a great investment option for its obvious tax benefits.

The market regulator SEBI has finally announced in January 2009 that mutual funds will not indicate returns in advance on fixed maturity plans now on.

References
