Large cash positions for long can affect fund's performance

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Representative image

Many fund managers seem to be unsure about current market conditions. But they are getting regular inflows from systematic investments plans. The result: Large cash positions in their portfolios (see table). While this strategy has the potential to protect a fund if the markets correct, it can also backfire in certain circumstances.

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Fund managers have understandably turned cautious in the wake of high valuations. Says Rajeev Thakkar, chief investment officer, PPFAS Mutual Fund, whose cash plus arbitrage position is at 16 per cent at present: "Currently there is strong momentum in the market, especially in the mid- and small-cap space and some Indian consumption-related themes. Increase in share prices have been greater than the underlying earnings or book value growth. Some investment managers believe that the size of opportunities justifies any valuation. While we recognise the potential, we will continue to be anchored by valuation parameters and will wait for the right opportunities to come by."

High inflows are another factor. "Between November 2016 and April 2017, diversified equity funds and balanced funds have received around Rs 76,000 crore. Fund managers are being judicious in deploying all this money," says Kaustubh Belapurkar, director-manager research, Morningstar Investment Advisor India.

Maintaining a high cash position for long carries risks for fund managers. One, if the markets run up while the fund manager is sitting on cash, his fund underperforms. Two, high cash allocation skews the investor's asset allocation. A conservative investor may decide to hold only 40 per cent equities in his portfolio. But if his fund manager holds 25 per cent cash in his portfolio, his effective equity exposure comes down to 30 per cent, affecting his long-term returns.

Many equity investors have a long investment horizon and are ready to take temporary overvaluation in their stride. "Investors use systematic investment plans to average their cost of purchase, so they don't want fund managers to take high cash calls," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

When fund managers take large cash calls, they must also redeploy the money at the right time. Many failed to do so in 2008-09. "When the 2008 crash happened, some fund managers managed to move into cash before the crash. However, when the markets went up again, they were unable to re-enter equities at the right time," says Dhawan. In falling markets, investors begin to pull out money, forcing fund managers to hold cash to meet redemption pressure. When the markets move up, a considerable portion of their portfolio is not deployed, causing underperformance.

Since these events, most equity fund managers prefer to stay invested. "We run our funds on a fully invested basis. Cash positions of about five per cent of the portfolio is maintained to meet day-to-day liquidity requirements. However, in case of high valuation levels, a defensive portfolio strategy may be adopted and cash levels may be increased to up to 10 per cent," says Roshi Jain, vice-president and portfolio manager-Franklin Equity, Franklin Templeton Investments-India. Monitor how long the high cash position lasts. If it lasts for, say, a month or two, it is fine. But if it continues for a couple of quarters, seek your advisor's opinion on whether to exit the fund.

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