BT Insight: Tata MF resorts to side-pocketing; what should investors do?

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After the IL&FS fiasco, in December 2018, the Securities and Exchange Board Of India (SEBI) permitted mutual funds to use side-pocketing option. Tata Mutual fund has just resorted to this option in its three funds that were hit due to investment in DHFL papers, which were downgraded by rating agencies. In a press release, Tata

Mutual fund said that it has informed all affected investors about using the side-pocketing option for three impacted schemes - Tata Corporate Bond, Tata Medium Term and Tata Treasury Advantage.

Tata Mutual Fund had an exposure of Rs 198.22 crore as on April 30, 2019 in DHFL papers across six schemes. The three schemes using side pocketing - Tata Corporate Bond, Tata Medium Term and Tata Treasury Advantage Fund - had an exposure of 28.21 per cent, 14.60 per cent and 3.77 per cent, respectively. They incurred losses of 29.69 per cent, 12.31 per cent and 4.06 per cent, respectively in one day. The fall is higher than the allocation because there is a possibility that the funds had to sell liquid papers to meet redemption requests during May, which may have increased the overall exposure to DHFL papers.

How Side-pocketing works

As the name suggests, side-pocketing allows mutual funds to segregate the portfolio into two, separating the bad assets (illiquid assets) from the good ones (liquid assets). Side-pocketing works in the interest of investors as it prevents panic redemption and ring-fences liquid assets. Side-pocketing also prevents the fund house from selling liquid papers to meet redemption requests. Also, investors who take the hit in side-pocketing get the full upside of future recovery when the credit event happens.

HOW SIDE POCKETING WORKS

- The portfolio will be separated in two- one main portfolio and the other segregated portfolio
- Investors will be issued same number of units of segregated portfolio as that of main portfolio
- Separate NAVs will be declared for both the portfolio
- Side pocketing will be effecting from the day of default
- There will be no redemption and subscription in the bad asset portfolio
- Units will have to be listed on stock exchange
- Post segregation, investors will be allowed to redeem from the main portfolio and continue holding the bad assets.
- New investors after side pocketing will get only good portfolio units
- In case there is any recovery from bad assets, it will be distributed among investors in proportion of the units held by them in bad portfolio

Mutual funds are allowed to use the side-pocketing option in case the rating agency has downgraded the debt paper 'below investment grade' or even lower.

"Rating agencies have downgraded long-term rating of Dewan Housing Finance Limited (DHFL) to default 'D' on June 5, 2019. AMC proposes to create segregated portfolio of securities of DHFL held by captioned schemes immediately after expiry of mandatory load free exit period of 30 days subject to approval by Trustee of Tata Mutual Fund. Ongoing subscription in the captioned schemes has already been suspended," said Tata Mutual Fund in the communication.

Impact of DHFL Default on Tata MF Schemes Using Side-Pocketing

Scheme	Amount (₹cr)	% Allocation	% drop in NAV
Tata Corporate Bond Fund - Retail Plan	51.93	28.21	-29.69
Tata Medium Term Fund - High Investment Plan	8.99	14.60	-12.31
Tata Treasury Advantage Fund - Regular Plan	63.89	3.77	-4.06

% fall as on June 4; % allocation as on April 30, 2019 *Source: Value Research*

In case a fund house uses side-pocketing option, it has to make changes in the scheme offer document and has to give investors an exit option without charging an exit load.

Tata Mutual fund in its communication has said that it has given its investors 30 days load free exit period, which will expire on June 14, 2019.

However, those investors who will exit now will get the redemption proceeds based on the current NAV, while those who stay invested until the day of the creation of segregated portfolio will be allotted equal number of units of segregated portfolio as well as main portfolio.

"Upon recovery of money from the segregated portfolio, whether partial or full, it will be distributed to the investors in proportion to their holding in the segregated portfolio," said tata Mutual fund in its communication.

The fund house has currently suspended subscription in three schemes. Many of other funds houses have also suspended the subscription to the impacted schemes.

What should investors do?

The worst is over. Whether investors should stay invested or use the load-free exit period will depend on multiple factors. Side-pocketing is a good option as it will help existing investors benefit if there is a recovery.

Experts believe that the decision to stay invested or exit will depend on the individual investor. "It will depend on case-to-case basis. The worst has already happened but whether the investor should remain invested or exit will depend on how much money the investor has put in the fund and how much he or she will need for the goal and how far they are from their goals," says Ankita Narsey, owner, Oaktree Financial Advisors.

If they can wait, they should use side-pocketing option as there are chances of recovery. Since September 2018, DHFL has repaid close to Rs 40,000 crore of financial obligations by selling its assets.

Vishal Dhawan, Founder & CEO, Plan Ahead Wealth Advisors says, "Side-pocketing is a good option for investors but before making the decision, investors need to look at the quality of the rest of the portfolio as the side-pocketing will take two-three months. If they are comfortable with the rest of the portfolio, they may stay invested."

Also, those who are planning to exit should also look at tax implications, he added. If an investor is invested for less than three years, she will not get indexation benefit and will have to pay short-term capital gains tax.