

# INTELLECT

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## MANAGING INFLATION



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# Managing Inflation Through Monetary Policy

**Monetary policy** is the process by which the government with help of the central bank controls:

- (i) the supply of money (Adding money into the economy)
- (ii) availability of money (Taking some money out of circulation)
- (iii) cost of money or rate of interest (Cost of credit)

These steps are taken to induce growth of the economy in a stable manner. When the economy grows in an unbridled manner, it causes an increase in the rate of inflation. Hence this growth has to be managed in such a way that inflationary forces are contained while the economy grows.

Monetary policy is generally referred to as either being an **expansionary policy** or a **contractionary policy**.

An expansionary policy increases the total supply of money in the economy while a contractionary policy decreases the total money supply in the economy.

Expansionary policy is traditionally used to combat a recession by lowering interest rates. Lowered interest rates means lower cost of credit which induces people to borrow and spend thereby providing steam to various industries and kick starting a slowing economy. An expansionary policy is also known as “accommodative” as it helps to spur growth of the economy.

On the other hands a contractionary policy results in increasing interest rates to combat inflation (or cool an otherwise overheated economy). An economy growing in an uninhibited manner leads to inflation which is referred to as an overheated economy. Hence increasing interest rates increases the cost of credit thereby making people borrow less. Due to lesser borrowing the amount of money

in the system reduces which in turn brings down inflation and slows or cools the economy. A contractionary policy is also known as a tight policy as it tightens the flow of money to contain inflationary forces.

Otherwise the monetary policy is neutral which neither aids growth nor slows it down.

It should be noted that be monetary policy should always be aligned to the fiscal policy of the government. (Fiscal policy is the government's borrowing, spending and taxation plans)

Monetary policy rests on the relationship between the interest rates in an economy, that is the price at which money can be borrowed, and the total supply of money. Monetary policy uses a variety of tools to control one or both of these, to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment.

There are several monetary policy tools available to achieve these ends.

1. Increasing interest rates (repo rates, reverse repo rates, etc).
2. Reducing liquidity by sucking out excess money from the system.
3. Increasing reserve (CRR) requirements.

All of the above tools have the effect of contracting the money supply and if reversed, they help in expanding the money supply.

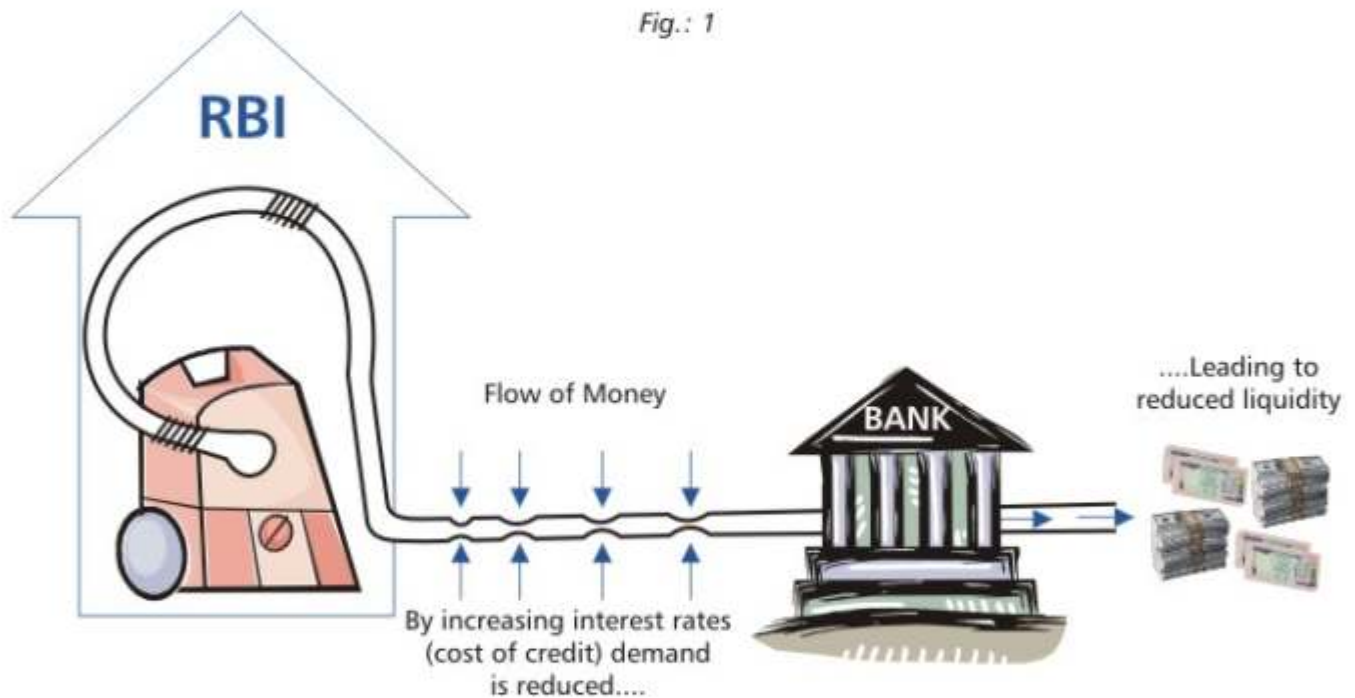
The monetary policy is set by special institutions called central banks (such as the Bank of England, the European Central Bank, the Federal Reserve System in the United States, the Bank of Japan or Nippon Ginko, the Bank of Canada, RBI etc.)

*How does the monetary policy function?*

The primary tool of the monetary policy entails managing the quantity of money in circulation through the buying and selling of various credit instruments, foreign currencies or commodities. All of these purchases or sales result in the increase or decrease of the base currency entering or leaving market circulation. The tools that are used by the RBI are as follows:

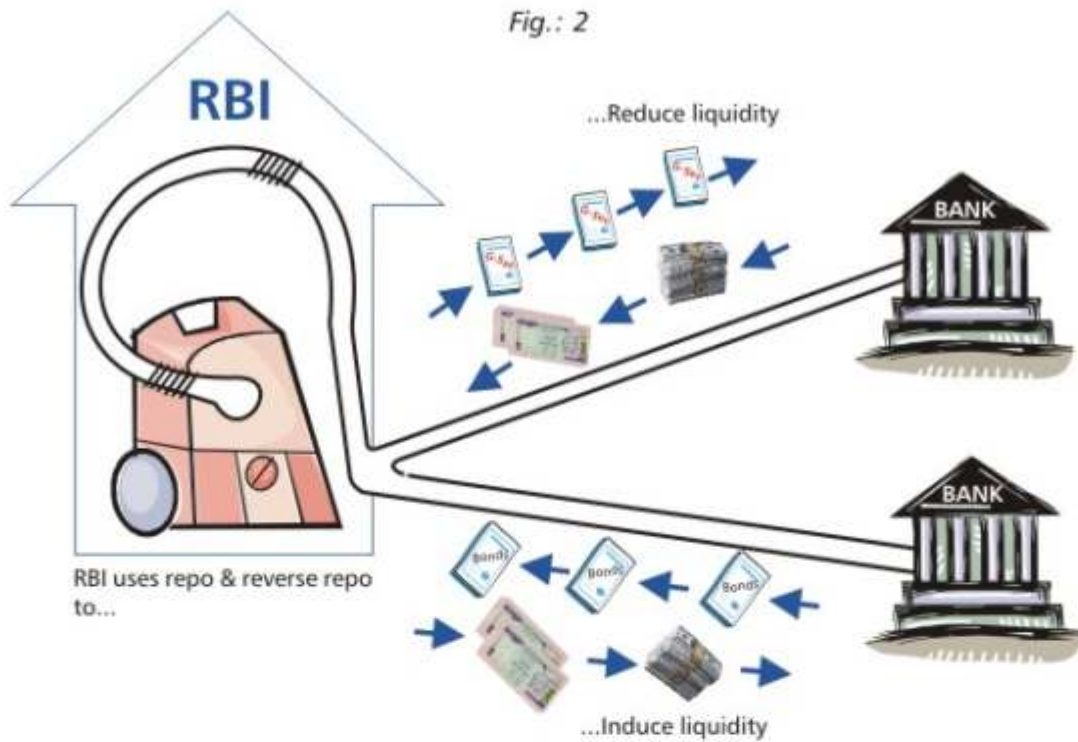
**Increase / decrease in lending rates:** From time to time, the RBI makes an adjustment in its lending rate (repo rate) in order to influence the cost of credit. By doing so it makes borrowing expensive, thereby discouraging borrowing. This brings about a reduction in the money in the system and helps lower the inflation rate. However a reduction in borrowing also slows down the economic growth and hence this method needs to be deployed after analyzing and understanding the impact of such a step on the economic growth. Due to this, the central banks resort to other methods as a means to the same end of lowering inflation.

Fig.: 1

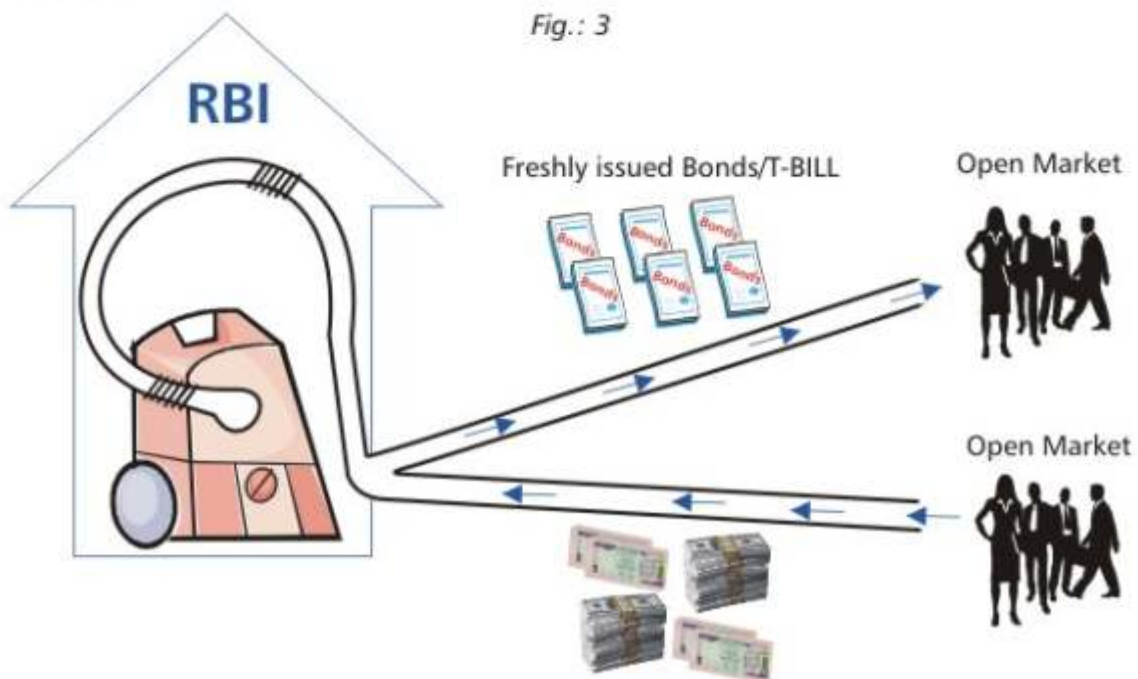


**LAF or Liquidity Adjustment Facility:** It helps to inject and sterilize liquidity from the economy. Under this, the RBI conducts daily auction of repos and reverse repos to manage liquidity in the system. (Repo is the activity through which banks borrow money from RBI while reverse- repo is the activity through which the RBI absorbs excess money from the system).

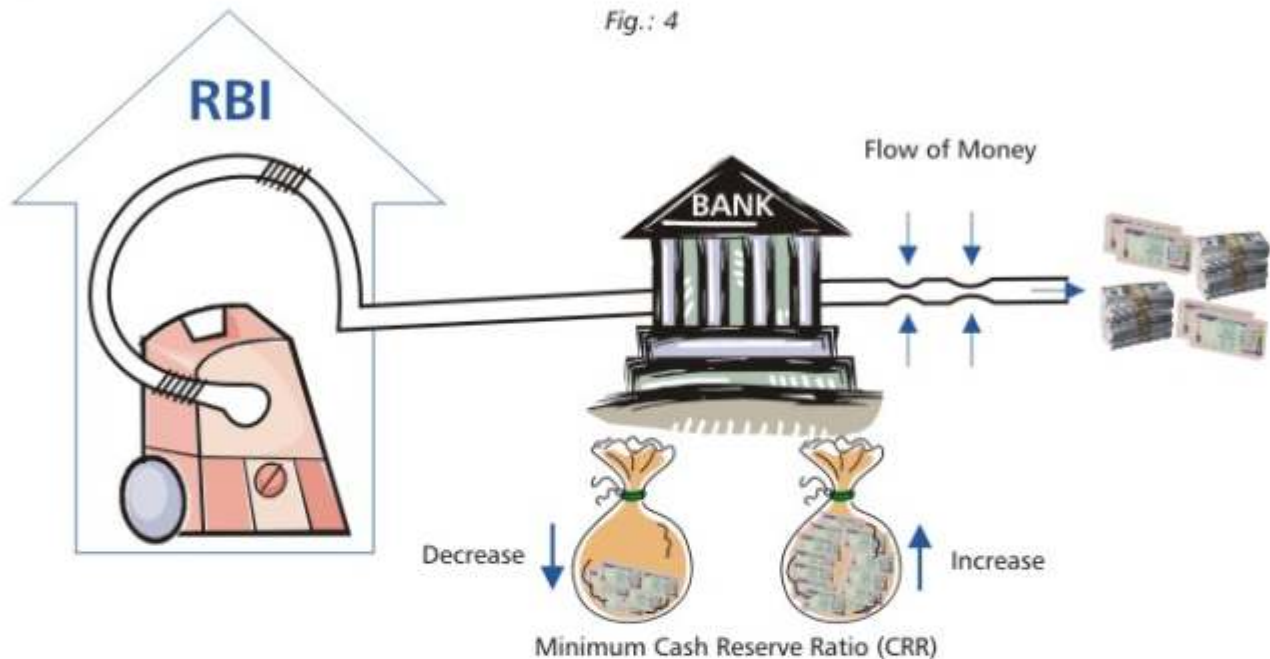
In other words, if the RBI wants to reduce money supply, it will absorb money against security of government securities. On the other hand if RBI wants to inject money into the system it would do so in exchange for bonds that is available in the banking system.



**MSS or Market Stabilization Scheme:** Whenever liquidity in the system increases, the RBI intervenes to stabilize the system. The central bank does this by issuing fresh Bonds and Treasury Bills in the open market. By injecting the bonds and sucking out the excess money, the RBI contains the inflationary forces and cools the economy. This tool was used extensively at the time when dollar inflows into our economy were very high, resulting in rupee appreciation. In order to stabilize the exchange rates, the RBI first bought additional dollars thereby stabilizing the rate of exchange. The excess rupees for the dollar purchases was subsequently sterilized through MSS. The MSS is generally a short term action and is independent of the government's borrowing program.



**CRR:** Cash reserve ratio is the statutory requirements levied by RBI, for banks to set aside cash with the RBI. The reserve requirement is a bank regulation that sets the minimum cash reserves each bank must hold in order to meet withdrawal demands. It is defined as the percentage of total deposits that the bank holds as cash. The reserve ratio is sometimes used as a tool to contain inflation. By increasing the CRR, the RBI decreases the lending capacity of the bank to the extent of the increase in the ratio. Thus when the CRR was raised from 7.5% to 8.25% the banks were deprived of lending to the extent of 75 basis points of their deposit value.



The People's Bank of China too uses change in reserve requirements as an inflation-fighting tool and has raised the reserve requirement nine times in 2007 alone.

However, there are several western countries that do not deploy this tool for inflation containment. Cash reserve ratio in several countries across the world are depicted in the table as under:

*Cash reserve ratio in various countries*

Country	Required Reserve Ratio (%)
Australia	None
Canada	None
Mexico	None
New Zealand	None
Sweden	None
United Kingdom	None

Country	Required Reserve Ratio (%)
Eurozone	2.00
Slovakia	2.00
Switzerland	2.50
Chile	4.50
Pakistan	7.00
India	8.25
Latvia	8.00
Burundi	8.50
Hungary	8.75
Ghana	9.00
United States	10.00
Sri Lanka	10.00
Bulgaria	12.00
China	16.50
Estonia	15.00
Zambia	17.50
Croatia	19.00
Tajikistan	20.00
Suriname	35.00
Jordan	80.00

# Inflation and commodity futures

Commodity futures have been in the limelight over the last few months. Some have felt that it is one of the key reasons for fuelling inflation and has aided the prices surge for some commodities.

As a result of this, the government has banned trading in some commodities like wheat, soya, oil, chana, rubber and potato.

As expected, the move has come in for a lot of criticism from various pockets of the market, especially the commodity brokers. Understandably, no trading means lower volumes and loss of brokerage income.

However, let us take an unbiased look and try to understand the relationship between commodities futures trading and inflation.

*So to begin with, let's understand what are commodity futures.*

A Futures contract (or Futures) is a product which gets traded in a commodity exchange. It is a contract on any underlying commodity like Gold, Rubber etc. Under this contract, the settlement is done at a predetermined price on a future date entered at the time of signing the contract.

For example,

1. On May 1, Mr. A agrees to buy 1kg of Gold from Mr. B and the settlement of this trade to be done on June 30, 2008.
2. The rate at which the deal will be settled will be decided on May 1.
3. In other words, irrespective of the price movement in Gold between May 1 and June 30, the deal will be settled at the price decided on May 1. This becomes a futures contract.

Thus, futures' trading helps to effectively hedge the risk of upwards movement in the prices of

commodities. For instance, a farmer who is expecting a harvest of rice after 3 months is exposed to the risk of price fluctuations. If prices rise he will have nothing to complain but in case the price falls then he will have to bear the losses.

Hence in order to mitigate this risk, the farmer can sell the same quantity of rice in the futures market at the current price with a promise to deliver the same at the specified future date.

Obviously, if the price rises in the spot market, the farmer will still have to deliver the agreed quantity of rice at the agreed price. He will thus have to incur an opportunity loss by selling his harvest at the agreed contract price as against the market price.

However this is what sets up the market and acts as motivation for the buyer of the futures contract.

However, a person using futures trading for hedging his underlying exposure/ investments must not worry about this opportunity loss as his objective is to guard himself against uncertainties.

Now, using futures in this way for genuine hedging does not cause any major problems. However, problems arise when people start to speculate using futures trading.

For example, a person who does not have any rice to sell agrees to sell predicting a fall in price. Thus he is taking a chance. If prices were to fall in line with his forecast, he would then buy the rice and immediately sell it at the agreed higher price based on the contract and pocket the difference as his profit. If more people similarly start to speculate and sell, the prices will get depressed in the futures market which will also have a downwards effect on the prevailing prices.

In the same manner, if speculators start purchasing in the futures market based on their forecast that prices are set to rise, the demand that gets aggregated in the



futures market leads to price rise. When such a scenario occurs, traders in the spot market get tempted to hoard the commodity and sell it at a higher cost in the future. This kind of a situation impacts the prices in the spot market driving it upwards and causes inflation rates to rise.

The following example will illustrate the impact of futures market on the spot market.

Let's assume that the current market price of wheat is Rs.20/- per kg and the futures price for July month delivery is Rs.21/-. If many traders think that the prices of wheat could rise in the coming weeks due to some factors? They would not buy additional quantities of wheat from the spot market since they will have to make provision to store the same which would be both cumbersome and costly. Hence they buy into wheat futures.

This incremental demand caused the price to rise from Rs.21 to Rs.22. If this continues, the price can go up to any levels depending on the demand supply factors in the futures segment.

Now, if it rises to levels like Rs. 25 or Rs. 26, the spot sellers might be induced to wait for more time before selling their stock. This will result in decrease in supply in the spot market leading to price increases there as well.

This is the concern that has led to ban on futures trading so that it does not result in undue speculation.

The detractors of this policy measure have their own arguments against this move:

1. The Wholesale Price Index (WPI) has been close to 8% which is an area of concern. But since the contribution of some of the banned commodities is only 4.2% approximately, it means that a 10% rise in these commodities will result in a roughly 0.42% change in the WPI index.
2. The futures market being the main source of information for the farmer helps him to plan his

production of crops in a steady and scientific manner. It is important to note that commodity production has a long gestation period and supply cannot keep pace with fluctuating demand. Hence information about the future becomes all the more essential.

For example, the futures market will give the farmer an indication that one of his crops, let's say wheat, is trading at a high price. This information will allow him to plan his future crop in which he will increase the proportion of wheat instead of, let's say sugarcane, which is being traded at a much lower price in the futures market.

This kind of planning is advantageous on several counts

- a. It helps the farmer plan for better profits by focusing on crops which will give him better yields thereby increasing his productivity. In the above example the increase in supply of wheat combined with the decrease in supply of sugarcane will increase his productivity and provide better yields.
- b. The increased wheat and decreased sugarcane supply (w.r.t the example discussed above) due to the adequate and accurate information brought about by the existence of futures market helps in moderating the prices of both commodities in the long run. The information that futures trading provides is transparent and truly representative. It helps the common man (farmer) plan his activity in a scientific manner.

However in the absence of the futures market, the farmer gets the price set by the government in the spot market rather than the prevailing real demand. This leads to subsequent shortages leading to price escalation in the long run. After all production volumes cannot be increased at short notice. Also, it allows unscrupulous middle men who are better informed to use unfair means such as hoarding etc for personal gains.

# Monetary Policy - Linkages Across Economies

While the developed economies have been losing sleep over the risks of financial meltdown and recession, the worry of emerging economies has been 'Rising inflation'. China's inflation rate has jumped to 8.3% from 2.2% in early 2007; Russia's is running at 13.3% (see chart). HSBC forecasts that the average inflation rate in emerging economies will rise to 6.6% this year, the highest in ten years.

One reason for this rise in inflation is the surge in food and energy prices. Food accounts for a bigger share of spending in emerging economies like India than in developed economies like the US. Therefore rising grain and meat prices have a bigger impact on emerging economies than developed ones. While this is the supply side problem, lax monetary policies are also to be blamed for adding fuel to the inflationary forces.

As America comes to terms with the possibility of a recession, emerging economies on the other hand are displaying handsome growth rates in the vicinity of 6.5% which is about four times that of developed nations. Thus some amount of decoupling is being observed. But this decoupling effect is not seen in the monetary policies of developed and developing nations and this linkage in monetary policies complicates matters.

Let us go back to the period which witnessed the housing boom in America. It is interesting to note that emerging nations are partly to blame for the sub-

prime problem that subsequently reared its ugly head. During this period, China and Gulf oil exporters purchased American Treasury bonds. This was done for the following reasons :

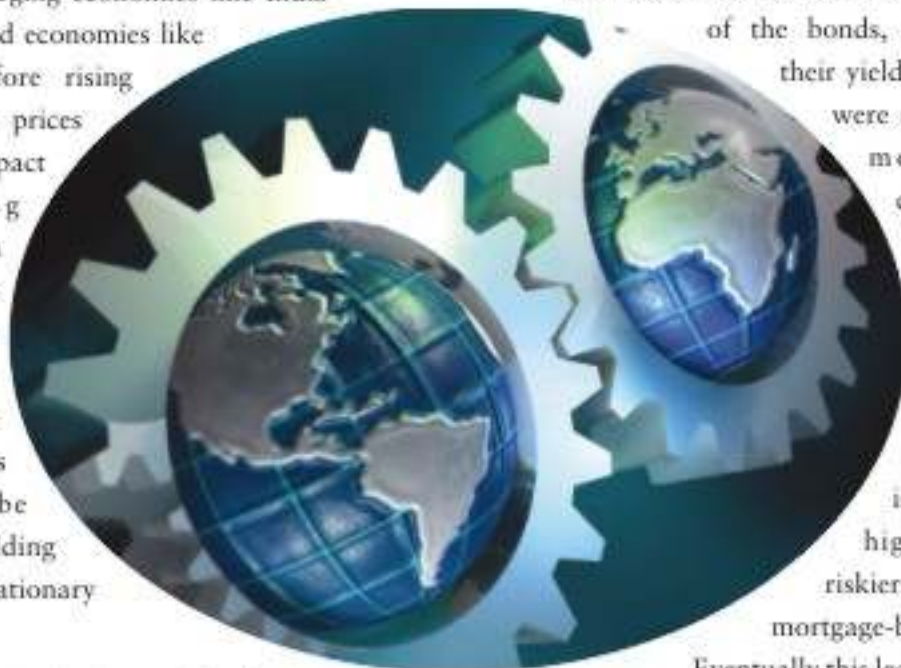
1. To park their savings in a stable asset like the US dollar
2. In order to hold down their currencies which would benefit their export strategies.

It was this demand of US Treasury Bonds by these nations which lead to the increase in the price of the bonds, thereby reducing their yields. Since the yields were not attractive any more, it drove domestic investment into real estate giving rise to the housing boom. Low yields also encouraged investors to seek higher returns in riskier assets, such as mortgage-backed securities.

Eventually this led to the bursting of the housing bubble and the infamous sub-prime problem.

So the monetary policies of some countries driven purely by the need to control exchange rates in a way started this entire problem. It is this same exchange rate policies that are leading emerging economies to run overly loose monetary policies.

Many emerging countries still peg their currencies to the dollar but most try to limit the amount of appreciation. This means that as the Fed cuts rates there is pressure on emerging economies to do the



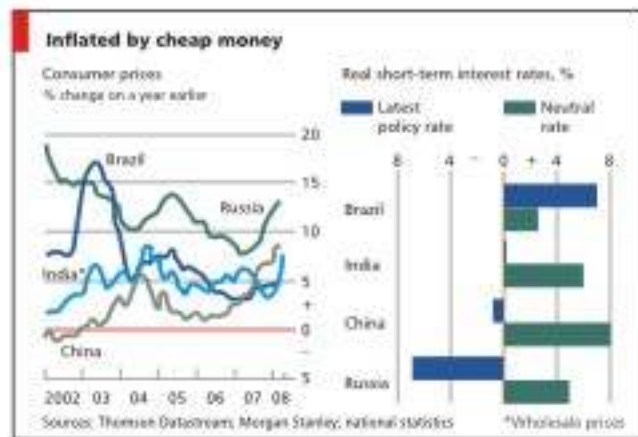
same, to prevent capital inflows from pushing up their exchange rates. However they should actually be doing just the opposite as rising inflation is what they should be combating. However by cutting interest rates and inducing demand, they are only adding fuel into the inflation fire. This surging demand in emerging economies boosts commodity prices and further reduces the spending power of developed nations like the US. Hence their central banks cut rates further. Thus the interest rate cycle begins once again across several nations leading to more growth in inflation and more suffering.

Such loose monetary policies have had startling results with regards to real interest rates. In China and Russia, actual real rates are negative against

measures that central banks use, such as banks' reserve requirements (both India and China have been steadily increasing them). Nevertheless, it is no coincidence that Brazil has the lowest inflation rate of the four countries. Russia, with the lowest real interest rates, has the highest inflation. This also explains what drives the Indian government to increase CRR on a regular basis and desist from increasing interest rates. If interest rates are increased, economic growth, which is already showing signs of a slow down, will further decelerate. And if rates are decreased, then inflation will boost up rise up further.

Another manner of managing overheated emerging economies is to let their currencies rise. This would help to curb inflation by reducing import prices, and a flexible exchange rate would create more room for an independent monetary policy without getting too caught up in following the monetary policies of developed nations. As is the case with every policy, there are cautions that need to be observed. Allowing these currencies to appreciate too much could lead to a flood of foreign capital as was the case in India very recently, eroding export competitiveness.

Yet another option and the one most likely to be pursued is to do nothing apart from slapping on some temporary price controls, and hope that inflation pressures will soon ease. The Indian government did adopt this policy during the earlier part of the year with the hope that inflation pressures would ease out. However since inflation continued to rise, the RBI has had to slam on the monetary brakes by increasing the CRR rates.



estimates of neutral real rates of 8% and 5% respectively (Neutral rates are those that would balance economic growth as well inflation favorably for the nation). In India, real rates are close to zero still far below the estimated neutral rate of 6%. Only in Brazil are real rates positive and above the neutral rate. Admittedly this ignores other tightening

# Understanding Fiscal Deficit



The government needs money for its huge expenses. We can broadly divide government expenses into two types:

1. Revenue expenses
2. Capital expenses.

The money spent by the government for paying salary to its staff is revenue expense, and the money spent for constructing a hospital is capital expense.

So how does the government meet these expenses?

The government finances its expenses by

1. Revenue by direct and indirect taxes.
2. Revenue by non-tax means which include:
  - **Revenue receipts:** These include dividends received from public sector companies, fees, fines, forfeitures etc.
  - **Capital receipts:** These include sale of PSUs, recovery of loans, borrowings of the government.

Revenue receipts are recurring in nature like the salary you earn while capital receipts are occasional in-flows like the proceeds you may receive on selling your house.

So where is the deficit?

- The expenses that the government incurs are always more than the income it makes. This difference or deficit is known as "Fiscal Deficit". It is expressed as a percentage of GDP.

- The financing of this deficit is known as "deficit financing".

So how is this deficit financed?

- **Through government borrowings:** It is due to this reason we had included borrowings of the government as revenue in one of our earlier point.

OR

- Through printing of additional currency notes.

Which is a better option then?

- Borrowing money from the market is a better option because if the government were to print more notes it would increase supply of money in the economy thereby reducing its "buying power" and causing inflation.
- Inflation would hurt one and all making the government un-popular.
- Therefore borrowing from the market is a better option as it does not alter money supply. But this too cannot go on endlessly. To understand this let's look at the next Point.

Government borrowings too have a limit.

- Borrowing money from the market cannot be an endless strategy purely because there is limited money in the market and needs to be made available for other borrowers as well.
- Too much of borrowings will drive up interest rates making credit expensive and thereby putting pressure on prices.
- Hence the only way to control the deficit in the long run is by spending less and earning more.

## Winners across product categories



**Tata Balanced Fund**  
Balanced Fund Category

**Tata Infrastructure Fund**  
Diversified Equity Fund Category

**Tata Liquid Fund**  
Liquid Fund - Institutional Category



### CNBC-TV18 - CRISIL MUTUAL FUND AWARDS

Past Performance is no guarantee of future results

**Ranking Methodology:** Tata Infrastructure Fund - Growth was among the only two schemes that won the CNBC-TV18 - CRISIL Mutual Fund of the Year Award in the Diversified Equity Funds Category. In total 47 schemes were eligible for the award universe. Tata Balanced Fund was the only schemes that won the CNBC-TV18 - CRISIL Mutual Fund of the Year Award in the Balanced Funds Category. In total 15 schemes were eligible for the award universe. Tata Liquid Fund - Super High Investment Plan (SHP) was the only schemes that won the CNBC-TV18 - CRISIL Mutual Fund of the Year Award in the Liquid Funds - Institutional Plans Category. In total 12 schemes were eligible for the award universe. Schemes present in all four quarter CRISIL CPRs (Composite Performance Rankings) were considered for the award. The award is based on consistency of scheme's performance in the four quarterly CRISIL CPR rankings released during the calendar year 2007. The individual CRISIL CPR parameter scores averaged for the four quarters were further multiplied by the parameter weight as per the CRISIL CPR methodology to arrive at the final scores. The scores of individual parameters for each of the four quarterly CRISIL - CPRs in 2007 are considered individually for the schemes eligible in each of the categories. The eligible schemes are scaled with the best score for each quarter. The average scaled scores constitute the parametric scores. The final weighted average score for each scheme is arrived by applying an assigned weightage, as in the CRISIL - CPR, to each of the parametric scores. The analytical framework looks at NAV movement for the analysis of risk adjusted returns.

Publisher of ranking data: CRISIL FundServices, CRISIL Ltd.

**Nature & Investment Objective:** **Tata Liquid Fund (TLF):** An open ended high liquidity income scheme. The investment objective of the scheme will be to create a highly liquid portfolio of good quality debt as well as money market instruments so as to provide reasonable returns and high liquidity to the Unitholders. **Applicable loads:** Entry Load: Nil, Exit Load: Nil. The schemes are open for ongoing resale / repurchase / switch offered at NAV based process with applicable loads. **Tata Infrastructure Fund (TISF):** An open ended equity scheme. The investment objective is to provide income distribution and/ or medium to long term capital gains by investing predominantly in equity / equity related instrument of companies in infrastructure sector. **Tata Balanced Fund(TBF):** An open ended balanced fund. To provide income distribution and/ or medium to long term capital gains while at all times emphasising the importance of capital appreciation. **Applicable Loads for TISF and TBF:** Entry Load (other than SIP): For each investment amount less than Rs 2 cr: 2.25%; For each investment amount greater than or equal to Rs 2 cr: Nil. No entry load shall be charged for direct purchase/switch-in applications accepted by the AMC. Exit Load (other than SIP): For investment amount less than Rs. 2 crs: 1% if redeemed on or before expiry of six months from the date of allotment. For investment amount greater than or equal to Rs. 2 crs: Nil. Entry load for SIP\*: 1%. Exit Load for SIP\*: If redeemed on or before expiry of 24 months from the date of allotment: 1.25%. If redeemed after 24 months Nil. \*The above SIP load structure would be applicable for SIP amount upto Rs 10 lakhs per installment. For SIP installment above Rs 10 Lakhs, the prevailing load structure for investment other than SIP will be applicable. No entry load shall be charged for direct purchase/switch-in applications accepted by the AMC. **Statutory Details: Constitution:** Tata Mutual Fund has been set up as a trust under the Indian Trust Act, 1882. **Sponsors & Settlers:** Tata Sons Ltd., Tata Investment Corporation Ltd. **Investment Manager:** Tata Asset Management Ltd. **Trustee:** Tata Trustee Co. Pvt. Ltd. **Risk Factors:** • Mutual Fund and securities investments are subject to market risks and there can be no assurance and no guarantee that the scheme will achieve its objectives. • As with any investment in stocks, shares and securities the NAV of the units issued under the scheme can go up or down, depending upon the factors and forces affecting the capital market. • Past performance of the previous Schemes, the Sponsors or its Group affiliates is not indicative of and does not guarantee the future performance of the Scheme. • Tata Infrastructure Fund, Tata Liquid Fund and Tata Balanced Fund are only the name of the schemes and does not in any manner indicate either the quality of the scheme, its future prospects or the returns. • The sponsors are not responsible or liable for any loss resulting from the operations of the scheme beyond the initial contribution of Rs. 1 lac made by them towards setting up the Mutual Fund. • Investment in fixed income securities are subject to interest rate risk, credit risk and liquidity risk. • The scheme being sector specific will be affected by risks associated with the Infrastructure Sector. Derivatives require the maintenance of adequate controls to monitor the transactions entered into, the ability to assess the risk that a derivative adds to the portfolio. Risks in using derivatives include the risk of default of counter party, mis-pricing and the inability of derivatives to correlate perfectly with underlying assets, rates and indices. For scheme specific risk factors and other details please read the offer document of the scheme carefully before investing. For offer document and application form, please contact your nearest AMC Offices.

Celebrating **10 years**  
of consistent performance

Tata Pure Equity Fund is proud to celebrate 10 years of consistent performance. The past decade has seen numerous ups and downs in the capital markets. But Tata Pure Equity fund has consistently outperformed the market over the long term and delivered good returns to its investors.

**Performance at a Glance (%) CAGR as on 31st May 08**

Since Inception	Last 5 years	Last 3 years	Last 1 Year
32.48	49.64	33.69	16.40

**TATA**  
**PURE EQUITY**  
**FUND**

(An Open Ended Equity Scheme)

Past Performance of the Scheme may or may not be sustained in future. Benchmark Return(SENSEX) Last 1 year 12.83%, Last 3 years 34.67%, Last 5 years 38.80%, Since Inception 14.85%. Returns are given for growth option. Dividends assumed to be reinvested. While calculating returns dividend distribution tax is excluded.

Call us at: 1800-209-0101 SMS: 'TMF' to 57575 E-mail: kiran@tataamc.com Website: www.tatamutualfund.com

**Nature and Investment Objective:** Tata Pure Equity Fund: An open ended equity scheme. To provide income distribution and / or medium to long term capital gains while at all times emphasising the importance of capital appreciation. **Load Structure (other than SIP):** Entry Load: For each investment amount less than Rs 1 crore: 2.25%; For each investment amount greater than or equal to Rs 1 crore: Nil. Exit Load: For each investment amount less than Rs. 1 crore: 1% if redeemed on or before expiry of six months from the date of allotment. For each investment amount greater than or equal to Rs. 1 crore: Nil. **Load Structure (SIP):** Entry Load : 1%; Exit Load : If redeemed on or before expiry of 24 months from the date of allotment : 1.25%; if redeemed after 24 months : Nil. This SIP load structure would be applicable for SIP amount upto Rs 10 lakhs per installment. For SIP installment above Rs 10 lakhs, the prevailing load structure for investment other than SIP will be applicable. No entry load shall be charged for direct purchase/switch-in applications accepted by the AMC. **Statutory Details:** Constitution: Investment Manager: TATA ASSET MANAGEMENT LTD. **Trustee:** TATA TRUSTEE COMPANY PVT. LTD. Tata Mutual Fund has been set up as a trust under the Indian Trust Act, 1882. **Sponsors & Settlers:** Tata Sons Ltd., Tata Investment Corporation Ltd. **Risk Factors:** • Mutual Fund and securities investment are subject to market risks and there can be no assurance and no guarantee that the scheme will achieve its objectives. • As with any investment in stocks, shares and securities the NAV of the units issued under the scheme can go up or down, depending upon the factors and forces affecting the capital market. • Past performance of the previous Schemes, the Sponsors or its Group affiliates is not indicative of and does not guarantee the future performance of the Scheme. • Tata Pure Equity Fund is only the name of the Scheme and does not in any manner indicate either the quality of the Scheme, its future prospects or the returns. • The sponsors are not responsible or liable for any loss resulting from the operations of the scheme beyond the initial contribution of Rs. 1 lac made by them towards setting up the fund. • For scheme specific risk factors and other details please read the offer document of the scheme carefully before investing.