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Invest with 6-12-month view for higher returns than liquid funds

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Inflows into money market funds (MMFs) dropped sharply from ₹44,573 crore in July to ₹2,210 crore in August, according to the Association of Mutual Funds in India (Amfi). Investors with a horizon of 6-12 months may nonetheless consider investing in these relatively low-risk funds.

How they work

MMFs invest in short-term instruments with maturities of up to one year, such as treasury bills, certificates of deposit (CDs), commercial papers (CPs), and repos. "They offer liquidity similar to liquid funds, but have the scope to offer slightly higher yields," says Devang Shah, head - fixed income, Axis Mutual Fund.

"While other categories of funds (within one-year duration) have a narrower range to manage portfolio duration, MMFs have greater flexibility to

manage duration from very short-term up to one year," says Amit Somani, deputy head - fixed income, Tata Mutual Fund.

Why flows fluctuate

Flows are largely driven by corporates and institutions, which pull money out at the end of a quarter. "In July, corporates and institutions redeployed funds after meeting quarterly tax and advance payment obligations. This led to a surge in flows that month. In August, flows moderated as they reallocated liquidity to meet working capital and regulatory needs," says Shah.

There were rate cuts amounting to 50 basis points in June. "MMFs continued to offer an alpha of 20-35 basis points over liquid funds. This attracted significant institutional money in July," says Somani.

Less volatile

MMFs invest in less volatile, highly liquid instruments. "These funds are positioned as

defensive products and can possibly give marginally higher returns than liquid funds," says Joydeep Sen, an independent debt expert. Shah observes that they offer high liquidity, lower credit and interest rate risk, and diversification across issuers.

MMFs must keep a portion of their portfolio in treasury bills. "This enables them to absorb the impact of any unexpected volatility in flows," says Somani.

The six-month to one-year yield stands at 6.25-6.50 per cent. Returns from these funds will be in this range after deducting expenses. "Investors can expect around 75-100 basis points of alpha above the repo rate or overnight rates over the next six to 12 months," says Somani.

Risks exist

MMFs carry some duration risk. "They can be slightly more volatile than liquid funds," says Sen. Somani cautions that investors must monitor portfolio quality and exposure to riskier instruments. Shah points out that post-tax returns may not always beat inflation, and net asset values (NAVs) can dip during mark-to-market or credit events.

Single-digit returns

Period	Returns (%)
1-year	7.6
3-year	7.2
5-year	5.9
10-year	6.6

Returns are for direct plans. Above one-year returns are annualised. Source: PBCS.in

Match horizon with maturity

Investors should align their holding period with fund maturity. "Avoid investing for a fortnight to one month. These funds may show some volatility in the short term, especially during periods of sharp interest rate movements," says Sachin Jain, managing partner, Scripbox.

According to Sen, MMFs suit investors with a horizon of 6-12 months. These funds are more liquid than fixed deposits (FDs). "Once investors have crossed the six- to seven-month period, their returns would be similar to those offered by FDs. In addition, they would enjoy 100 per cent liquidity and similar taxation as FDs," says Jain.

Check portfolio quality

Review the asset management company's (AMC) track record and the fund's portfolio composition. Check the portion of the portfolio invested in A1+ holdings. Of the A1+ holdings, check how much is in treasury bills, CDs, and CPs.

Treasury bills are the safest. Bank CDs are also perceived as safe. In the case of CPs, the risk depends on the issuer. Check the issuer's credit rating and whether it is a blue-chip or an unknown company.

Check the fund's yield-to-maturity (YTM). "Different funds may have different average maturities, leading to variation in YTM of 30-40 basis points," says Jain.

He advises comparing expense ratios and avoiding funds with very small assets under management.