Credit Risk Funds

Why in News

Recently, Franklin Templeton Mutual Fund (one of the largest fund houses in India) has decided to close its six **credit risk funds.**

- The reason behind the step was **severe market dislocation** and **illiquidity** caused by the **Covid-19** pandemic.
- A **fund house** is a company that invests the pooled money of investors to buy financial securities like stocks, mutual **funds,** equities, etc.

Key Points

- Definition: Credit-risk funds are **debt funds** which have **at least 65% of their investments in less than AA-rated** (i.e. in lower-rated) **papers.**
    - **Debt funds** aim to generate returns for investors by investing their money in avenues like bonds and other fixed-income securities.
    - **Investment grade** refers to the quality of a company's credit. Anything below 'BBB' rating is considered a non-investment grade.
- They have the **potential to offer 2-3% higher returns** compared to risk-free higher rated papers.
- **Return:** Credit-risk funds make returns in two ways:
    - One, they earn interest income on the securities they hold.
    - Secondly, since they invest in lower-rated securities, if the rating of a security is upgraded, they have the potential to make capital gains.

- **Risk:**
    - **Liquidity risk:** Credit-risk funds have a higher liquidity risk. If a bond with a lower rating in the portfolio defaults or faces a further downgrade, it may be difficult for the fund manager to exit the holding.
    - **Concentration risk:** If **the portfolio is concentrated or has high holdings in any single business group,** then even a single default by business group will affect the entire portfolio.

Source: IE