Money Market Funds

What is money market?

Money market is part of financial markets which deals with very short term fixed income instruments. Money market instruments have maturity of less than 1 year. Participants in money market are usually banks and other financial institutions, institutional investors, corporates etc. Retail investors can also participate in money market through debt mutual funds.

What are money market instruments?

Money market instruments, as mentioned before, mature within a year. They include overnight securities (securities maturing overnight) like Tri-Party Repos, Commercial Papers (CPs), Certificates of Deposit (CDs), Treasury Bills etc. Issuers of money market instruments are Government (Treasury Bills), companies (CPs) and financial institutions (CDs).

Characteristics of money market instruments

- **Very short duration / maturity:** The duration of money market instruments can range from one day to one year.
- **Highly liquid:** Due to their very short maturities, money market instruments are highly liquid.
- **Moderately low interest rate risk:** Interest rate sensitivity of a fixed income security is directly related to its maturity. Longer the maturity, higher is the interest rate risk. Since money market instruments have very short maturities, interest rate risk is relatively low. Shorter the duration of a money market instrument, lower is its interest rate risk.
- **Relatively lower yields:** The yield of a fixed income security is directly related to its maturity. Longer the maturity, higher is the yield of a fixed income security. Since money market fund's instruments have shorter maturity / durations compared to Government Bonds, non-convertible debentures (NCDs), State Development Loans (SDLs) etc., their yields are lower than longer duration securities.
- **Credit risk:** Credit risk of a money market instrument depends on the issuer of the instrument. Treasury Bills have no credit risk because they are issued by the Government of India. Similarly, Tri Party Repos have virtually no credit risk because they are backed by Government Securities. Other money market instruments may have credit risks. The credit rating agencies provide ratings for money market instruments.

Mutual funds investing in money market

While all debt mutual funds may invest in money market instruments, following categories of debt mutual funds invest primarily in money market:-

- **Overnight Funds:** These funds invest in instruments that mature overnight
- **Liquid Funds:** These funds invest in instruments that mature in less than 91 days
- **Ultra-short Duration Funds:** These funds invest in instruments such that the Macaulay Duration of their portfolio is 3 to 6 months
- **Low Duration Funds:** These funds invest in instruments such that the Macaulay Duration of their portfolio is 6 to 12 months
- **Money Market Funds:** These funds invest in instruments with maturities of up to 1 year

Money Market Funds

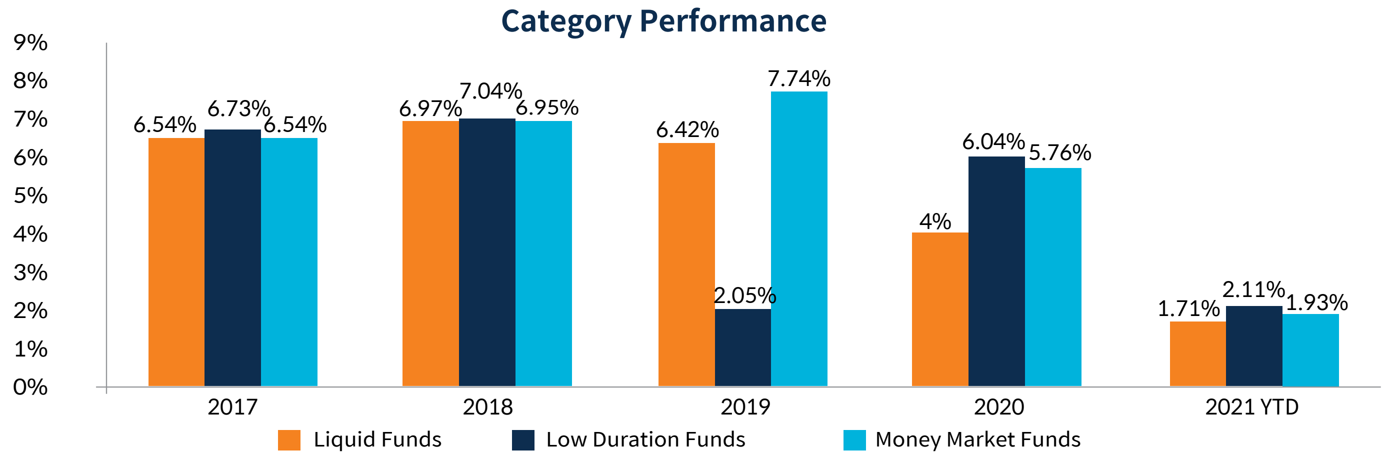
Money market funds have the broadest mandate among all other debt schemes investing primarily in money market instruments. Fund managers have the flexibility to invest across maturities of up to 1 year depending on prevailing interest rate and credit spreads environment. Since these funds can invest in instruments with maturities of up to 1 year, you need to have minimum 1 year investment tenure for these funds. Investors should note that, these funds may have credit risks. One should check the credit quality of these funds before investing.

Why invest in Money Market Funds

- **High liquidity** – Underlying instruments have short maturities. These funds usually do not charge exit loads.
- **Moderately low interest rate risk** – Money market instruments have relatively low interest rate sensitivity (risk) compared to longer duration instruments.
- **Relatively higher yields than overnight and liquid funds** – Yields of money market funds are relatively higher than overnight and liquid funds.
- **Suitable for short term investments in current situation** – The inflation trajectory is uncertain due to uncertainty in commodity prices, especially crude and restrictions on movement of goods due to COVID-19. Long term yields may harden further. Yields in the 1 day to 1 year maturity range are relatively less volatile / more stable.

Performance of Money Market Funds versus other debt categories

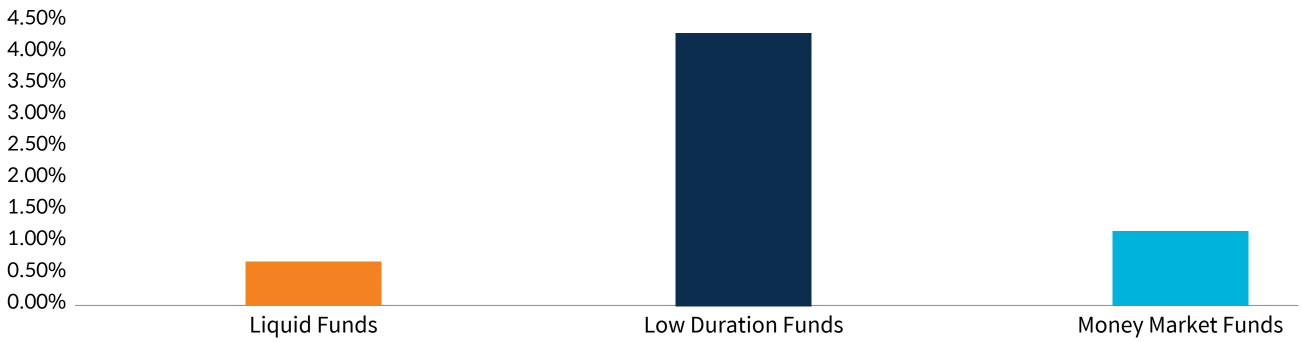
The chart below shows the category average annual returns of Money Market Funds versus several other popular debt fund categories over the last 5 years; during this period we had seen different interest rate (both rising and falling rates) environments. You can see that, money market funds are among the most consistent performers over 1 year investment tenures.



Source: Advisorkhoj Research. Average of annual returns of all funds in specified categories was taken to calculate to category average returns. 2021 YTD returns are as on 20th July 2021. Average returns are the return for the categories of Mutual Fund and in no way indicate the returns of a particular mutual fund scheme. Disclaimer: Past performance may or may not be sustained in the future.

Volatility of Money Market Funds versus other debt categories

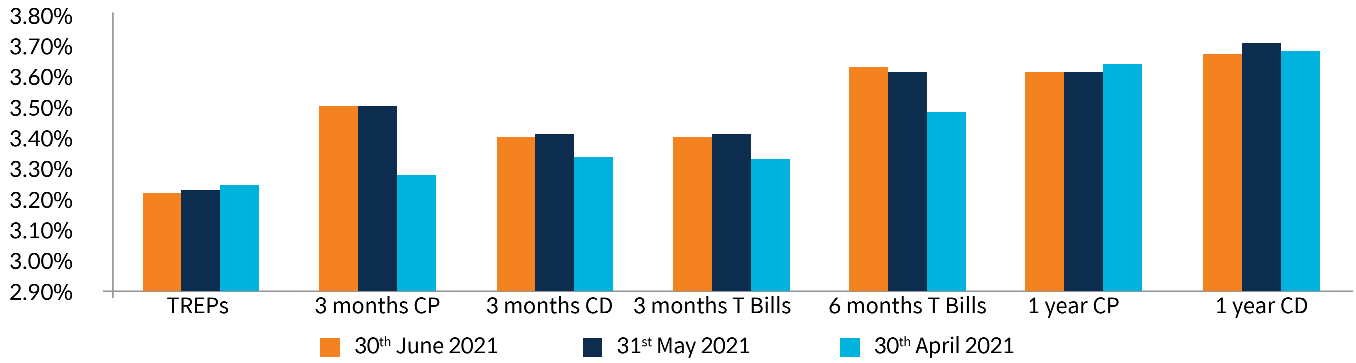
The chart below shows the category average Standard Deviations of monthly Money Market Fund returns versus Standard Deviations of monthly returns of several other popular debt fund categories over the last 3 years. Standard Deviation of returns is a measure of volatility. You can see that money market funds are relatively less volatile.



Source: Advisorkhoj Research (as on 20th July 2021). Average of annualized standard deviations of calendar month returns of all funds in specified categories over last 3 years was taken to calculate to category average standard deviations. Average returns are the return for the categories of Mutual Fund and in no way indicate the returns of a particular mutual fund scheme. Disclaimer: Past performance may or may not be sustained in the future.

Money Market Yields

The chart below shows the yields of money market instruments of different maturities. You can see that while yields have hardened in the 3 to 6 month range, there has not been much change in yields towards the 1 year end of the maturity spectrum. Further, note that there has not been much change in yields between May and June. RBI is ensuring high liquidity in the financial markets and this will keep overall yields low. Money market fund managers may find opportunities in different maturity segments which may result in providing stable returns to investors.



Source: Bloomberg, Advisorkhoj Research (as on 30th June 2021). Disclaimer: Past performance may or may not be sustained in the future. Note: The average returns are the return for the categories of Mutual Fund and in no way indicate the returns of a particular mutual fund scheme.

Role of money market fund in asset allocation

Prudent asset allocation calls for diversifying your fixed income investments across debt funds of different duration profiles. Allocation of different durations will depend on your risk profile and financial goals – short term, medium term and long term. Money market funds are suitable for short term financial goals e.g. investment tenures of 1 – 2 years. Investors with low risk appetites may also invest in these funds for longer investment tenures. Investors can also invest in money market funds through Systematic Investment Plans (SIPs). By investing through SIP, one can take advantage of volatility in NAVs to average your purchase price (Rupee Cost Averaging).

Things to look before investing in Money Market Funds

- You should always invest according to your risk appetite and financial needs.
- Money market funds are suitable for investors with moderately low risk appetites.
- The investor should have reasonable expectations of returns when investing in money market funds. The yields of these funds are lower than longer duration funds.
- Though these funds have relatively low interest rate risk, there may be some volatility depending on the interest rate situation. The investor should look at the duration profile of the scheme and invest according to their risk appetite.
- Money market funds may be subject to credit risk. Investor should look at the credit quality profile of the scheme before investing. Money market instruments rated A1 or A2 usually have low credit risks.
- Investor needs to have an investment horizon of at least 1 year for investing in money market funds.

Taxation of Money Market Funds

Short term capital gains (investment held for less than three years) in Money Market Funds will be added to your taxable income and taxed according to your income tax slab rate. Long term capital gains (investment held for more than 3 years) in Money Market Funds are taxed at 20% after allowing for indexation benefits. There is no withholding dividend distribution tax but dividends paid by Money Market Funds during a financial year will be added to your income and taxed according to your income tax slab rate.

Difference between Money Market and Low Duration Fund

Investor can get confused between Money market category and low duration category as both are for short term investment.

Money market funds invest in debt and money market instruments that mature within 1 year. Low duration funds invest in debt and money market instruments such that Macaulay Duration of the scheme is between 6 to 12 months.

Low duration funds actively manage duration to generate higher returns. As a result, low duration funds carry interest rate risk and hence can be volatile. Money market funds, on the other hand, have the flexibility to invest in instruments of up to 1 year maturity with the objective of generating stable returns. As such, money market funds tend to be less volatile than low duration funds, though yields of low duration funds tend to be higher.

Investors should consult with their financial advisors if Money Market Funds are suitable for their short term investment needs.