

Mutual funds demystified

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Continuing our WACC discussions, we will today examine in some depth how the 'Cost Of Capital' is arrived for the debt portion of a company's financing mix.

To understand the cost of capital, let us first put ourselves in the shoes of the investor who is providing the capital.

The cost of any type of capital can be simply stated as 'the opportunity cost to the investor of foregoing an alternative investment'.

In the case of debt, we should substitute the word 'investor' with the word 'lender'. To explain this in simple terms – let us assume that you had some surplus money for which you want a stable source of regular income. Debt capital is that type of capital designed to pay you interest for the period of borrowing as well as return your principal amount by the end of the agreed period.

A few of the common types of debt capital are bank fixed deposits, company fixed deposits, non-convertible debentures and bonds, to name a few. The rate of interest payable by the borrower (ie the bank or the company concerned) is generally known and agreed to right at the beginning. So given that different banks and companies offer varying rates of return how do we make a decision on whom to give your hard earned money to? Many of us may simply give it to that borrower who offers the highest rate of interest. But many of us do not! And it is the correct thing to do.

Why? Because the interest rate market is just like any other market in that there is a bidding process that decides the right price. For example, if you have been to any subzi-mandi, you will find that most tomato sellers quote roughly the same price. This price is decided in the morning when the market opens based on the supply of tomatoes which has arrived in the truckloads. As you can intuitively understand, the more the truckloads of tomatoes that have arrived, the lower will be the market price for the day.

This is referred in the subject of economics as the Demand-Supply Equilibrium. While I will not delve into more jargon – what this means is that if any individual seller tries to offer a different price (ie increase the price to make more profit or decrease the price to sell more tomatoes), the other sellers will also follow suit so that he loses any advantage from that action. Hence the market price is always the perfect and correct price.

Now, on closer observation you may find that some tomato sellers do indeed quote a higher or lower price. If you enquire of them the reason for the same – he will offer you a one word answer: QUALITY. Either the tomatoes are tastier because they are from a farm of better origin such as the cooler climate of Ooty or they last longer because of better packaging.

The reverse may also be true – the seller might be trying to get rid of some poor quality tomatoes because they are a day older or because they got slightly damaged in transit. Hence we need to modify our earlier statement to say that 'the market price is the perfect price for products of the same quality'.

What we have stated for the tomato market is true for any market place anywhere in the world – whether it is a physical market such as the vegetable market or an electronic/virtual market such as the stock market or the financial instruments (including debt) market.

So then how is price determined in the debt capital market?

First of all the market price in this case refers to the rate of interest.

While it is difficult to visualize a vegetable-market-like situation for determining the correct rate of interest – in actuality the process is very similar. For example let us look at the supply aspect: in the debt capital market, this is represented by the number of banks or corporate sector who want to raise money from lenders such as you. The more the number of such issuers, the higher the rate of interest would be because of the same Demand-Supply Equilibrium effect.

The second aspect is the 'QUALITY' aspect. How is quality determined here? Very simple – what you are expecting from the investment (or lending) is to get your interest and principal promptly on the agreed date. Depending on your (or any independent credible agency's) assessment of the borrower's ability to do the same, you would rank the borrower as either of higher or lower quality and hence settle for a lower or demand a higher price (rate of interest).

I will close the discussion at this point and deal with the issue in greater detail in subsequent issues.

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