

Mutual Funds Demystified

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In the last article, we did a quick recap of the concepts that we had been covering over the past few months. We will now take up the thread of our discussions and continue them. To put things in the tight context, we are currently discussing the QUALITY aspect of determining a company's borrowing cost from the capital markets.

Why are we interested in the borrowing cost?

First, because if you are looking at investing, for instance, in a public issue of the company's debentures, you need to be satisfied that the rate of interest offered on it is commensurate with the risk involved.

We are, of course, helped by the fact that these debentures have to be rated by a credit rating agency, but it always helps to understand the process by which the rating agency arrives at the rating (essentially the 'quality' aspect that we have been discussing).

To summarize, there is an inverse link between the rating and the rate of borrowing

- higher the rating, lower is the borrowing cost and vice versa though the degree may depend on various other macro factors.

This is, however, not the main reason that we delved so deeply into the cost of debt capital. The main reason is this: even for investing in shares, it is important to know the cost of debt capital.

Because, in the process of arriving at the correct share price, one of the process involved is the 'discounting' of future cash flows of the company at an appropriate rate to arrive at the net present value (NPV) of the company (to remind readers, share price is nothing but NPV divided by the number of shares outstanding).

The appropriate rate that we referred to is known as the Weighted Average Cost of Capital (WACC). The WACC is arrived at by assigning weights to the 1. Cost of Equity and the 2. Cost of Debt by their respective proportion in a company's balance sheet.

Hence the cost of debt is important because it is a component of the WACC.

There is one more surprising reason why we need to know the cost of debt: knowing this is important even to arrive at the cost of equity! How and Why? That we will address in detail in coming issues. For the time being let me just leave it at that, having whetted your appetite!

Here the point that I wanted to make was that 'even if you are interested in investing only in the equity market, it is vital to know the cost of debt capital and that is why we are spending so much time in getting the basics right.

I thought of addressing this issue before we resume our discussions because there were a few queries from readers on why we are dwelling so much on debt when most retail investors in mutual funds are interested only in the equity markets!! I hope the above discussion addresses the issue.

Hence, it is important to be aware of a company's rating for short, medium and long-term debt while evaluating whether the share price of a company is undervalued or overvalued. In fact if you look back over the past few years, you will find a few instances where the downgrade (or upgrade) of a company's debt by a credit rating agency, immediately impacts the share price.

So 'quality' of a company is extremely important to judge and that is why credit rating agencies are expected to undertake much analysis before arriving at a rating.

Once you arrive at the correct assessment of 'quality' how do we apply it in determining the correct interest rate? I will address the topic briefly here and carry it forward next month.

The interest rate is determined by adding a risk premium based on the company's quality to the rate at which a risk-free borrower would be able to raise debt capital.

Who is a risk-free borrower and how is his rate determined? (And on a more facetious note – as my son asked me – if he is 'risk free' why should he pay any interest at all and should he not get money free).

The answer to the second question is something that we addressed in one of our early articles: The lender needs to be compensated for 'being asked lends his money to someone else instead of exercising his natural preference to spend the money for his own enjoyment' - there is a price to be paid for 'postponing his consumption'.

The answer to the first question is that generally the government of a country (not government of states within the country) is assumed by the market to be the risk-free borrower.

The next question begs itself – do not governments default and if so why are they considered 'risk free'. That is a question that space does not permit me to address now, but is one which I will do so in a future discussion.

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