PARALLEL UNIVERSE

UTI Not Long for This World

Mounting investor losses and allegations of corruption have hastened the demise of the Indian government's mutual fund.

BY JON THORN

Imagine a world in which a government-controlled investment company manages 60% of its nation's mutual-fund assets, and where the fund isn't subject to the control of a national securities regulator or indeed to any regulation whatsoever. Imagine that the largest fund holds 16% of total national mutual assets, and that instead of sticking to a mandated asset allocation of 60% bonds and 40% equities, has reversed that proportion.

Then imagine that although the fund provides a price-per-unit basis for its 10% dividend payout, and unit investment and redemption price, the price isn't based on the aggregate net asset value (NAV) of the fund's holdings. Instead, it provides an "administered" price, which it states is the "smoothed" (and unaudited) NAV per share.

Imagine no longer. Welcome to the Unit Trust of India, a living nightmare for the 20 million investors in its largest scheme, US-64. Globally, there's nothing comparable to UTI. In the United States, it would be like combining CalPERS, Fidelity and Vanguard all into one, and then the next top 10 mutual funds. Corporates and individuals see UTI as a branch of the Indian government and have always believed it to be the embodiment of state underwritten security and probity. Sadly, they're now discovering this to be false, not the least since senior UTI personnel, including its former chairman, were detained for questioning or arrested on charges of fraud and corruption.

Since the Indian budget was announced on February 28, the Ketan Parekh stock market scam has driven stock liquidity down by 80%. The major changes to market operation and management that the regulator, SEBI, has since put into place have changed for the better many assumptions about investing in India. The bright new dawn of this new stock market was July 2, when T+5 rolling settlement was introduced and the cash and futures market was finally separated.

But that same day UTI announced its suspension of redemptions from US-64 for six months. If the whole of the Bombay Stock Exchange 30 Index had issued profit warnings, the effect on market confidence would have been less.

The UTI US-64 had been suffering a wave of redemptions from mainly corporate investors for nearly six months before the announcement, and it was that wave of accelerating redemptions that forced it to bolt the door. It was common knowledge in the market that US-64 was using a unit price that had not moved down much for almost one year, although the stock market had fallen sharply. It was obvious therefore that the fund's portfolio could not add up to the redemption price.

Many investment professionals have difficulty understanding this specific point – so important for understanding the parallel topsy-turvy universe of Indian finance – so it demands repetition: The unit price of US-64 was and is substantially higher than its actual NAV per share.

The UTI had been on borrowed time since 1998, when problems first surfaced and the government bailed it out and set up a committee to make recommendations to fix what was clearly a nonviable business. That committee was headed by Deepak S. Parekh, chairman of the Housing Development Finance Corporation, respectively, the most respected figure and most admired institution in Indian finance.

The Parekh Committee made 19 recommendations of which 16 have been implemented. The three that have not – conversion to NAV pricing, independent and legal regulation, and a return to the investment remit of investing mainly in debt rather than equity are, of course, the hardest things to fix and exactly what created UTI's problems in the first place.

UTI was handed a golden opportunity to clean up by the stock-market bubble that developed in India from 1999 to 2000. It is widely believed that this may have been the only time the past decade when UTI's published unit-price reflected the value of the underlying NAV. But it failed to act, assuming the markets would climb higher still.

Although the origin of these problems is now of only academic interest, remaining investors who have in effect financed the over-NAV redemptions of the early redeemers especially deserve a good reason why more was not done to fix UTI's problems while they were more easily fixable.

Some of UTI's senior managers were clearly remiss in dealing with fundamental and obvious problems. Neither did the government fulfill its duties. The Finance Ministry appears not to have pressured UTI strongly enough to implement the Parekh Committee's recommendations.

Far worse than incompetence, arrogance or dereliction of responsibility is the alleged fraud and corruption among some senior UTI staff currently being investigated by the police. The allegation is that some senior managers, including P.S.Subramanyam, the former UTI chairman, recommended purchase of shares in a private placement by Cyberspace Infosys, a "concept" stock that seems to have lacked even a concept. This was contrary to a strong recommendation made by UTI's research department.

There have been many and strongly worded government statements that UTI"s small investors are protected and will get their money back. While voters should not be defrauded, the government has more to do than fill in UTI's asset hole.

Since July 2, UTI reinstated redemptions for a maximum of 3,000 units (circa $638) per investor. It also announced that full redemptions will become available from May 2003 and that until then the redemption NAV will increase by 10 paise per month for the next 20 months, and that full NAV pricing will start in January 2002. The flip side of this disaster is that there are today few stock markets in the world where the government has both stated clearly that it will do all it can to underpin prices and has an obvious interest in pushing up prices, which is what it will need to do to get UTI's NAV closer to its unit price.

The move back to debt from equities must also be completed without UTI dumping stocks in a market with few buyers. The government is trying to get other financial institutions to buy blocks of stock direct from UTI, and it hopes that they will do this at a premium for size-to-the-market price. (Full disclosure: The selling has started and we at India Capital Fund PCC have recently purchased stock from UTI, although not at a premium). Clearly this is a large overhang in the market, especially for some individual stocks; normal market service will not be resumed until the overhang has gone away.

A lot of focus has been on the larger equity holdings in the US-64 portfolio, many of which are good companies, as the stock market melt-down has crushed the prices of all but the best and the luckiest. The debt portfolio however has not yet been closely scrutinized, and more horrors may lurk as some weak companies start to default. One of the reasons US-64 moved so heavily out of government debt and into equities was the search for yield, cash and earnings to meet its liabilities.

The history of markets show it's always a bad idea for a government to manage assets, whether on behalf of taxpayers or investors. How UTI and US-64 emerge from this mess is now a heated debate. Whatever the avenues pursued, a lot of investors will have lost a lot of money.

Strangely enough, there's no sense in India that radical surgery is needed to amputate UTI from the government. But this may change over time. The future of the savings industry in the world's second-most populous nation is definitely being debated, and it's a safe bet that UTI eventually won't be India's mutual fund manager of first choice or last resort.

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