

BEYOND THE OBVIOUS**SEBI Guideline on Multi Cap Funds: Minimal fallout expected****I. The guideline and its rationale****A. The guidelines**

SEBI in its September 11, 2020 circular has partially modified the scheme characteristics of multi cap funds (drawing reference to its October 06, 2017 circular regarding categorization and rationalization of Mutual Fund Schemes) as under:

- Minimum investment in equity and equity & equity related instruments (out of total assets) enhanced to 75% (from current 65%).
- Further, a minimum of 25% (of total assets) to be invested in equity and equity related instruments in each of i) large cap, ii) mid cap and iii) small cap category of companies.
- All the existing multi cap Funds shall ensure compliance with the above provisions by February 2021.

B. Rationale for this directive

- SEBI has expressly mentioned the two objectives of i) diversifying the underlying investments across market caps and ii) offering 'True-to-Label' fund schemes behind the measure.

Thus, a multi cap fund should typically have adequate representation from mid and small cap securities too. Currently, if we glance at the portfolios of multi cap funds, most of the larger schemes tend to have a skew towards Large Cap companies (as can be seen from the table following).

II. Current state of the multi cap funds and exposure

- As per current status, there are **35 open-ended multi cap schemes with a total AUM of Rs. 1,46,663 crore** comprising around 20% of all open-ended equity oriented schemes.
- If guidelines are enforced on an immediate basis, Rs.35,208 crore will need to be unwinded from Large Cap holding. Correspondingly an amount of Rs.40,497 crore (Rs.12,575 crore into Mid Cap and Rs.27,923 crore into Small cap) would need to be bought into as per Aug 2020 AUM data.
- As a perspective, the total **Free Float Market-cap of the Mid and Small cap segments is estimated to be near Rs. 1,60,000 crore.**
- **In other words, MFs will need to suck up 25% of the total available free-float M-cap in the market to comply with the proposed limits.** Even with higher prices, this would be a tough ask.

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Figure 1: Around Rs.35,000 Cr of Large cap holding would need to be reallocated to Mid Cap and Small Cap

| Name of The Scheme | % held | | | | Rs. Crore | | | |
|---|-------------|-------------|------------|------------|----------------|------------------------|---------------|------------------|
| | Large Cap | Mid Cap | Small Cap | Others | AUM | Reduction in Large cap | Add in Midcap | Add in Small Cap |
| 1 Kotak Standard Multicap Fund(G) | 77.7 | 18.3 | 1.2 | 2.9 | 29,714 | -8,224 | 2,005 | 7,078 |
| 2 HDFC Equity Fund(G) | 85.9 | 8.4 | 3.9 | 1.8 | 19,798 | -7,108 | 3,289 | 4,170 |
| 3 Motilal Oswal Multicap 35 Fund-Reg(G) | 88.9 | 4.8 | 4.7 | 1.6 | 11,240 | -4,373 | 2,267 | 2,287 |
| 4 Aditya Birla SL Equity Fund(G) | 68.2 | 23.8 | 5.8 | 2.2 | 11,023 | -2,003 | 127 | 2,119 |
| 5 UTI Equity Fund-Reg(D) | 65.8 | 27.1 | 5.5 | 1.7 | 10,983 | -1,733 | -228 | 2,146 |
| 6 SBI Magnum Multicap Fund-Reg(G) | 72.9 | 17.7 | 6.5 | 2.9 | 9,063 | -2,079 | 666 | 1,673 |
| 7 Franklin India Equity Fund(G) | 78.5 | 11.6 | 6.9 | 3.1 | 8,591 | -2,447 | 1,152 | 1,558 |
| 8 Nippon India Multi Cap Fund(G) | 53.1 | 24.5 | 19.0 | 3.3 | 8,053 | -248 | 37 | 480 |
| 9 Axis Multicap Fund-Reg(G) | 92.3 | 3.3 | | 4.4 | 6,434 | -2,724 | 1,395 | 1,609 |
| 10 ICICI Pru Multicap Fund(G) | 75.0 | 14.0 | 8.3 | 2.7 | 5,594 | -1,397 | 615 | 932 |
| 11 IDFC Multi Cap Fund-Reg(G) | 53.4 | 29.2 | 13.1 | 4.3 | 4,847 | -164 | -206 | 579 |
| 12 Parag Parikh Long Term Equity Fund-Reg(G) | 34.9 | 14.3 | 16.0 | 34.7 | 4,508 | 679 | 481 | 407 |
| 13 DSP Equity Fund-Reg(D) | 70.1 | 23.0 | 5.6 | 1.4 | 3,726 | -748 | 75 | 724 |
| 14 L&T Equity Fund-Reg(G) | 73.0 | 15.1 | 9.6 | 2.3 | 2,366 | -544 | 234 | 364 |
| 15 Canara Rob Equity Diver Fund-Reg(G) | 74.6 | 16.3 | 3.9 | 5.2 | 2,280 | -560 | 198 | 481 |
| 16 Tata Multicap Fund-Reg(G) | 67.8 | 22.4 | 8.3 | 1.5 | 1,695 | -302 | 45 | 283 |
| 17 Invesco India Multicap Fund(G) | 35.2 | 39.8 | 21.0 | 3.9 | 925 | 137 | -137 | 37 |
| 18 Baroda Multi Cap Fund(G) | 73.5 | 18.3 | 2.2 | 6.0 | 825 | -194 | 55 | 188 |
| 19 Principal Multi Cap Growth Fund(G) | 69.9 | 19.6 | 8.1 | 2.4 | 654 | -130 | 35 | 111 |
| 20 Sundaram Equity Fund-Reg(G) | 79.8 | 11.1 | 8.9 | 0.2 | 600 | -179 | 83 | 97 |
| 21 Edelweiss Multi-Cap Fund-Reg(G) | 73.9 | 14.8 | 9.5 | 1.7 | 560 | -134 | 57 | 87 |
| 22 BNP Paribas Multi Cap Fund(G) | 78.7 | 9.4 | 10.7 | 1.2 | 555 | -159 | 87 | 79 |
| 23 Union Multi Cap Fund-Reg(G) | 72.9 | 10.5 | 10.2 | 6.4 | 371 | -85 | 54 | 55 |
| 24 Mahindra Manulife Multi Cap Badhat Yojana-Reg(G) | 69.0 | 19.8 | 7.3 | 3.9 | 340 | -65 | 18 | 60 |
| 25 HSBC Multi Cap Equity Fund(G) | 76.9 | 15.5 | 6.9 | 0.7 | 330 | -89 | 31 | 60 |
| 26 LIC MF Multi Cap Fund(G) | 70.0 | 21.3 | 4.7 | 4.0 | 295 | -59 | 11 | 60 |
| 27 IDBI Diversified Equity Fund(G) | 68.0 | 18.3 | 11.8 | 1.9 | 290 | -52 | 19 | 38 |
| 28 PGIM India Diversified Equity Fund-Reg(G) | 62.1 | 18.4 | 14.2 | 5.3 | 226 | -27 | 15 | 24 |
| 29 Taurus Starshare (Multi Cap) Fund-Reg(G) | 82.8 | 12.6 | 2.4 | 2.2 | 200 | -66 | 25 | 45 |
| 30 Essel Multi Cap Fund-Reg(G) | 75.3 | 16.6 | 7.3 | 0.8 | 176 | -45 | 15 | 31 |
| 31 ITI Multi-Cap Fund-Reg(G) | 77.7 | 6.6 | 6.8 | 9.0 | 134 | -37 | 25 | 25 |
| 32 JM Multicap Fund(G) | 88.1 | 10.6 | | 1.3 | 131 | -50 | 19 | 33 |
| 33 Shriram Multicap Fund-Reg(G) | 71.4 | 12.8 | 2.4 | 13.5 | 58 | -13 | 7 | 13 |
| 34 BOI AXA Multi Cap Fund-Reg(G) | 46.4 | 19.4 | 21.7 | 12.5 | 40 | 1 | 2 | 1 |
| 35 Quant Active Fund(G) | 18.0 | 21.4 | 53.1 | 7.5 | 36 | 11 | 1 | -10 |
| Wt. Avg / Total | 74.0 | 16.4 | 6.0 | 3.6 | 146,663 | -35,208 | 12,574 | 27,923 |

Source: ACE-MF, ASKWA Research.

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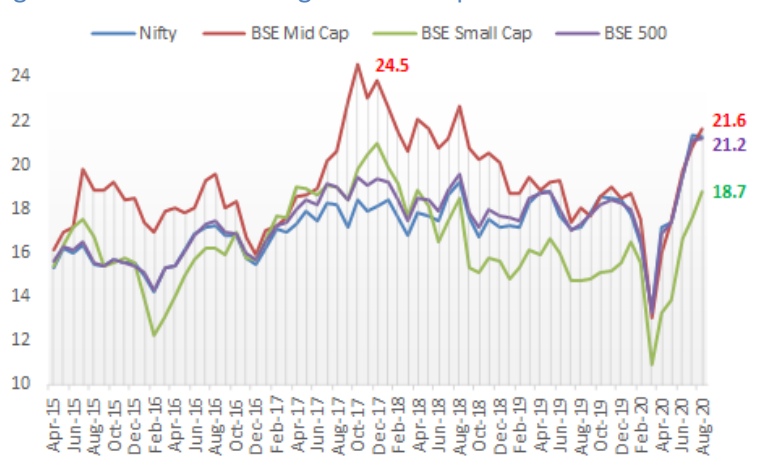
III. Likely Options for MFs

If enforced abruptly, there is likely to be disruptive impact of the sudden rejig order, even if it is allowed to be staggered over a period of six months, since price adjustment for this known change is likely to be frontloaded. We however, feel that this is a relatively low probability event due to the following options available with the AMC offering multi cap schemes.

Our discussion with AMCs who manage some of the largest multi cap funds suggests that MFs have the following alternatives to navigate without large scale disruption to their Fund schemes and the market (whilst complying with this SEBI directive).

- ✓ Make a representation to SEBI for allowing a 'Flexicap' category – which allows fund schemes to straddle across Large Cap, Mid Cap, Small Cap – without any minimum / maximum caps
 - ❖ If allowed, this could be the best possible solution – most multi cap Funds can be simply converted to 'Flexicap' Funds – causing almost zero disruption to the market
- ✓ Obtain approval from SEBI to transform classification of the multi cap Fund to:
 - Large Cap Fund (For e.g. Motilal Multi Cap 35 can be converted to a Large Cap scheme – Motilal Oswal AMC currently does not have any Large Cap Fund scheme)
 - Large & Mid cap
 - Focussed Fund (E.g. Parag Parikh Long Term Equity Fund can be converted to a Focussed category Fund – which allows upto 30 stocks in the scheme – currently met)
 - Thematic Funds (e.g. ESG fund)
- ✓ Merger of multi cap funds with other, more suitable categories (like Large Cap/Focussed)
- ✓ Forbearance from SEBI in terms of time allowed (or broad contours) by/of the guidelines

Figure 2: Valuations of large and midcap coincided in 2020 so far while only small cap is trailing



Source: Bloomberg, ASKWA Research

IV. Conclusion

Its early days yet. However, given the optical impact of the proposed change, near term volatility can be expected – both in terms of a possible rally in mid/small-caps and some impact on large-caps, in line with the putative flows.

However, there is strong reason to be cautious. There is possibility of elevated interest in the mid/small caps, driven by the news and potentially also by the large number of retail investors in the market today (nearly 4 million new accounts have been opened during the Covid-19 lockdown period alone). If this elevated interest is not backed up by matching institutional action as expected, there might be retracement in those stocks although the response could be asymmetric on the two legs.

MFs are likely to take a graduated approach – any large-scale change will have significant churning costs as well as market impact costs and can be detrimental to the interest of their investors.

There isn't a huge amount of daylight between Nifty and BSE Midcap valuations. While there is greater headline buffer in Small-cap valuations, the nature of the segment is prone to averages being skewed by a few extreme boundaries.

There are several stocks tables with potential "Ins and Outs" being circulated – they are ALL to be taken with large doses of skepticism. MFs are unlikely to venture into precipitous changes soon, they will explore the options discussed above and buying-on-news is always a risky activity.

Long term investors should keep their portfolios stable till clarity on the guidelines emerge.

V. Investment portfolios to play on the theme:

- Our recommended funds in the multi cap category are listed below. As pointed above, we expect the potential impact of the disruptive change from SEBI to be mitigated on account of reclassification and / or merger with existing schemes and / or regulatory forbearance from SEBI evolved through a consultative process. Hence, we are continuing with a hold recommendation on these funds.
 - Kotak Standard Multi Cap Fund
 - Parag Parikh Long Term Equity Fund
 - UTI Equity Fund.

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