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Effective risk controls

The propensity of investors and AMCs to chase high yielding funds is leading to higher credit risk-taking, says Dhawal Dalal, CIO - Fixed Income, Edelweiss AMC

Apr 21, 2017

Keeping the recent debt fund problems in mind, Value Research spoke to a few seasoned debt managers to get their perspective on top-of-mind questions for investors. Here, Dhawal Dalal, CIO - Fixed Income, Edelweiss AMC takes a few questions on this issue.

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Is the credit environment in India improving with the economy? If so, why do we have these episodes of sudden rating downgrades?
Barring a few untoward incidents, we have observed that the credit environment has generally improved. The banking system liquidity has improved steadily in the last one year. So access to capital for corporate borrowers has improved. Borrowers, who earlier weren't able to borrow below 10%, are now able to do so. With the recent reduction in bank MCLRs, market access is expected to be even better for credit-worthy borrowers.

As to the outlook for lower-rated borrowers, that is usually dependent on market conditions. When AAA rated papers are offering you sufficient yields, there is generally relatively lower demand for lower rated papers. But in 2016, yields on AAA rated bonds have declined from around 8% to

less than 7%. Therefore, investors who still seek 8%yield, are now forced to take on more risk to earn that yield. In fact, we at Edelweiss put out a note in December 2016 highlighting that yields in the PSU bond market had traded at a multi-year low and were perhaps not sustainable at those levels. We also highlighted that yields will have to decline further by 25 to 50 basis points if investors expected around 8% kind of return and that kind of decline was unlikely given the current macro-economic backdrop.

This is why AA rated credits, on selective basis, are perhaps attracting good amount of interest. Right now tax-free bonds are trading at 6.25-6.35%, so it is equivalent to around 9-9.1% on pre-tax basis. Today acceptable credits, which offer yield close to these levels, are finding decent buying interest.

You have been taking this view that credit quality is more important than yields for the last three years. But why do we find debt funds in short-term or low risk categories taking on lower-rated paper? Can they not avoid them?
There is significant amount of focus on asset growth among mutual funds these days. Since inflows generally follow near-term performance of the scheme, there is either some amount of credit risk or duration risk in the portfolio that may need active management.

It has also been observed that investors have been rewarding performance more than prudent fund management. As a result, credit quality has generally been nudged for performance as there is relatively lower focus on attribution of returns from the investors.

For example, if a particular type of fund delivered annualized monthly return of around 6.50%, investors should perhaps study sources of returns in the form of fixed accrual, price gains / losses, expenses etc. This analysis may help investors to identify true characteristics of risks in the portfolio.

We, at Edelweiss Asset Management, take our fiduciary responsibility seriously. We are focussed on creating wealth through prudent asset allocation and duration management in a transparent manner over the medium term.

How do you stay away from liquidity risks in the bond market?
Liquidity in the portfolio is like mirage in the corporate bond market. Fund manager thinks it is there. But when he or she needs it, it may not be there at his or her levels. So the best way to ensure some liquidity in the portfolio is through holding liquid g-secs, AAA bonds or top PSU names. A prudent fund manager will always have a pocket of liquidity in his funds

at all times.

Apart from this, fund managers ought to answer the following question before buying - 'who is the next buyer?' and 'at what level?' This is important. As answer to these questions may help fund managers analyse their portfolio positions & allocations in a different paradigm and give perspective on liquidity parameters.

Primary issuances in the corporate bond markets are picking up. Recently, supply of Basel III AT1 bonds has picked up. Maintaining sufficient amount of liquidity by answering these questions is paramount in our opinion.

What are the risk controls that you have put in place to avoid credit risks from manifesting?
At present, we have decided to restrict our portfolios to paper rated AA minus or above. We will have even those AA minus papers very selectively.

Apart from the qualitative and quantitative analysis that everyone does, our endeavour is to capitalise on the knowledge bank of Edelweiss and benefit from it. Edelweiss is a large financial conglomerate with multiple business lines ranging from agri-business to real-estate financing. We intend to benefit from the vast amount of knowledge, experience and relationships for our investments. We believe this may offer us an additional qualitative comfort on various credits over financial statements and external credit ratings.

We have also decided to be prudent with our exposure. Based on our assessment, we have categorized our credit list with an aim to take calibrated credit exposure in our fixed income funds. This will perhaps offer an additional layer of comfort to our investors, in our opinion.

In the May 2017 issue of MFI, we have presented a list of things that investors should know before investing in debt funds.