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Choose your Debt Funds wisely!

Dear Investors and Advisors,

All conversations with advisors or investors over the last few months are incomplete, even those primarily focused on equities, if there's no conversation on debt funds. The last two years, post the ILFS crisis till recent events, have undoubtedly been tough for a certain segment of debt funds. And while it is important that a lot of questions are asked and will continue to be asked, it is also important that we don't use this challenging period to run away from debt funds entirely or paint all debt funds in the same colours. This is extremely important because when we talk about asset allocation, it cannot be complete without debt allocations, and as Indians, we save, and debt will always form a significant part of our investments. As I always say, mutual funds will not win, till debt mutual funds don't. With the considerable tax advantage that debt mutual funds enjoy over traditional debt instruments like deposits, there is no reason why debt mutual funds cannot win.

One of the challenges in debt MF investing, quite frankly, has been the lack of awareness of the risks in debt funds, that comes from having a large FD background where the variables were more limited. How much will I earn and in what period, were essentially the two questions. Debt funds carry two types of risks – credit risk and duration risk, both are distinct. Credit risk is the risk factor that has hogged the news more recently, and is the risk associated with lending to more risky borrowers. For a large part of retail investors, credit risk should remain a satellite or one with minimal allocation (if an allocation at all). In an asset class like debt, where safety is paramount, credit risk may not be worth the extra bps, and in addition comes with liquidity risk.

The other risk is the duration risk, or the risk associated with bond prices moving because of interest rate fluctuations. Of late, in order to avoid credit risks, investors are also inadvertently taking on duration risk. Why does duration risk exist? Consider you hold a Rs 100 bond of 5 years maturity, with a 5% coupon, or Rs 5 to be paid annually. Now over the holding period of the bond, you will earn 5 tranches of Rs 5 each i.e. the coupon. Now imagine interest rates go to 6% suddenly. Your bond which was paying coupons of 5% will now become less valuable. Conversely, if interest rates fall to 4%, your 5% bond becomes attractive. Prices of bonds are thus inversely correlated to interest rates. As an extension, also note that the value of your bond will deviate more with interest rates if it has a longer time to mature (more coupon payments are outstanding) versus a shorter maturity. Longer duration bonds carry higher interest risk. Again, this risk is only risk in the interim. If you hold the bond till maturity, duration risk doesn't matter!

Now debt funds today, generate their returns from accruals – payments of the coupon and a small portion through price appreciation or depreciation based on interest rates. Debt fund returns go up when rates fall, because the appreciation factor becomes disproportionate. These returns may not be sustainable because when rates rise again, the gains reverse. Unfortunately, over periods like the last year where interest rates have fallen 1%, many investors are attracted to long duration and gilt funds. Over the last two months, flows into gilt funds have zoomed sharply and I suspect many investors, in a bid to avoid credit risk and attracted by previous one year returns, are jumping into waters they are not ready to navigate.

Year	Returns %	% change in AUM during the year
2007	8.50	547%
2008	10.98	16%
2009	1.22	131%
2010	6.60	-46%
2011	7.95	-24%
2012	10.09	439%
2013	5.59	27%
2014	13.64	-22%
2015	6.95	28%
2016	12.73	-7%
2017	3.81	-20%

Like any other asset class, investing in debt funds should also be done based on forward thinking and not using the rear-view mirror. Comparing historical returns of debt funds with current rates offered by other avenues, is not ideal. Flows in long duration funds spiked after a period of good returns, and then retracted when returns are negative due to a reversal in interest rate cycles. As an investor, remember rates go through cycles like equity markets and rise and falls are difficult to predict. Rates that are sub 4% today may rise when RBI normalizes rates!

So what should be an investor's approach when investing in debt funds with all these variables, at a time when interest rates are already low? Well for one, don't let low rates tempt you into taking credit risks. Secondly, focus on funds where you earn interest income and don't carry duration risk. For long tenure debt money, match your duration to the duration of your fund. I have a simple three -point debt strategy, which I would like to share with you. Divide your money into three buckets by goals. The first bucket is short term - money needed in less than three months, use overnight and liquid funds. The second bucket is for money needed between 3 months and 3 years – use arbitrage funds which carry neither duration nor credit risk and are tax efficient. And for over three years, use rolldown structures like Bharat Bond ETF which have defined maturities and then match your goals to respective maturities. Because of the rolldown structure, over the holding period, you eliminate duration risk.

Our team will be happy to answer more questions as you navigate the tides of debt funds. Happy investing!

Regards
Radhika Gupta