Aim to enjoy three benefits in one investment opportunity.

The Covid-19 pandemic has had a large bearing on the global as well as domestic financial markets. Even the hitherto steady fixed income space is shaken. Debt mutual funds reported outflow of Rs 1.94 lakh crore in March 2020, the second highest for the category since the IL & FS debt fracas in September 2018. While April and May saw inflows into debt funds, except the liquid category, most investor money has been invested in less risky categories such as Banking & PSU funds. The category witnessed net inflows of Rs 8,873 crore in May, the highest since the Association of Mutual Funds in India (AMFI) started declaring inflow/outflow and Assets Under Management (AUM) numbers as per the new categorisation in April 2019. In this article, we look at how this category presents a relatively less risky investment opportunity for investors.

Banking and PSU funds defined

Though Banking and PSU funds have existed for a long time, a separate category was carved out by the Securities and Exchange Board of India (SEBI) in October 2017 – one of the 16 new categories launched by capital market regulator as part of its recategorisation move to bring in uniformity and enable investors to make informed investment decisions. As per the SEBI mandate, Banking and PSU funds are open-ended debt schemes required to invest 80% of their assets in debt instruments of Banks, PSUs, Public Financial Institutions (PFIs) and Municipal Bodies.

Investment strategies followed by funds in India

Most of the schemes in this category aim to maintain an optimal balance of yield, safety and liquidity. Their strategy is to mitigate credit risk and generate returns through a blend of accruals and active duration management.

Accrual strategy involves buying short-term debt instruments and holding them till maturity, which reduces interest rate risk.

Duration strategy involves taking a call on the interest rate movement and accordingly adjusts duration of portfolio with an aim to garner better returns.

In addition, these funds are guided by the key principle of **SLR** - Safety, Liquidity and Returns.

For illustration purposes only

Credit and liquidity combo makes these funds right in a volatile environment

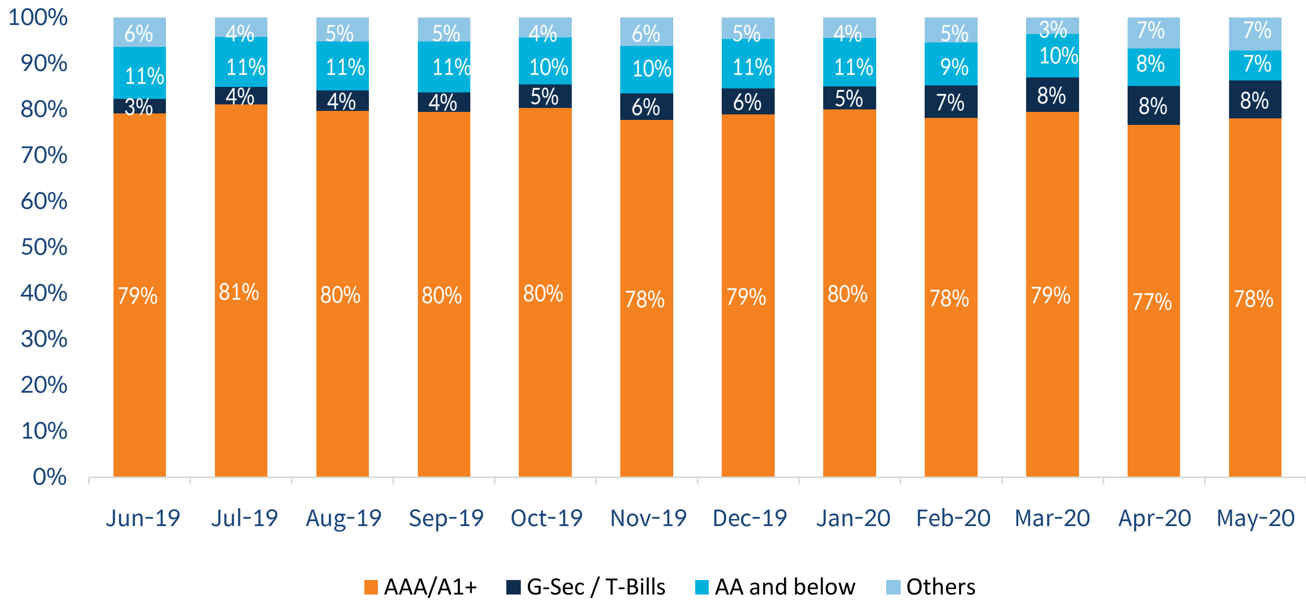
Let's start with credit quality. By design, these funds primarily invest in top-rated instruments of the debt market – bonds and debentures issued by Banks, PSUs and PFIs.

Some common examples of securities held by the category include NABARD, Indian Railway Finance Corporation, Food Corporation of India, Export Import Bank of India, National Highways Authority of India, Gail, NHPC, NTPC, Power Finance Corp and Power Grid Corporation of India.

Most of these bonds and debentures are AAA-rated. Issuers with AAA rating have relatively highest safety and lower credit risk than those with AA or below rating.The risk of default is very low in case of these instruments as they are supported by the government.

Analysis of the credit quality of Banking and PSU debt funds shows that exposure to higher-rated papers (AAA\A1+ and Government of India securities and treasury bills (GOI/T-Bills) remained constant in the one year that ended this May despite deterioration in investor sentiments.

Credit rating profile of Banking and PSU funds



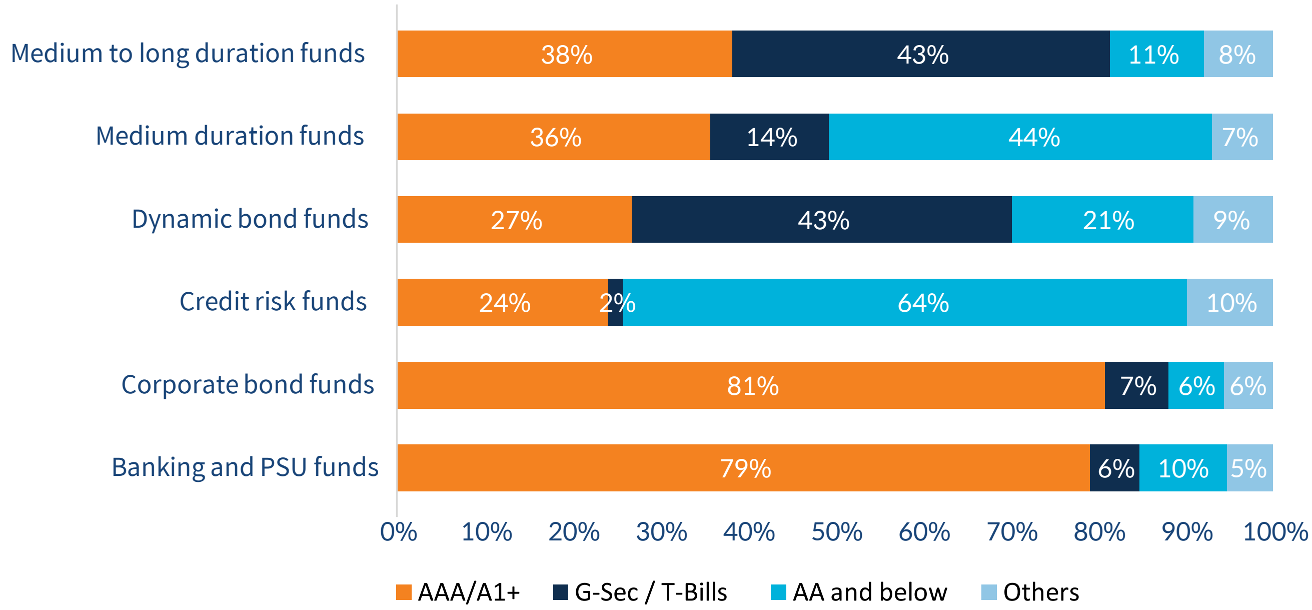
Source: CRISIL Research

Notes: CRISIL-ranked Banking and PSU funds for the quarter ended March 2020 are used for analysis.

Others include: Reverse repo, Collateralised Borrowing and Lending Obligation (CBLO), Tri-Party Repo (TREPS), net receivables, interest rate swaps, margin, call, mutual funds units, fixed deposit.

Credit quality comparison among debt funds shows that Banking and PSU funds have higher share of investments in top-rated papers versus most other categories.The average exposure of these funds to AAA and A1+ rated papers for year ended in May was 79% compared with 24% for credit risk funds, 81% for corporate bond funds, 27% for dynamic bond funds, 36% for medium duration funds and 38% for medium to long duration funds.

Credit rating profile of Banking and PSU funds vis-à-vis other debt categories



Source: CRISIL Research.

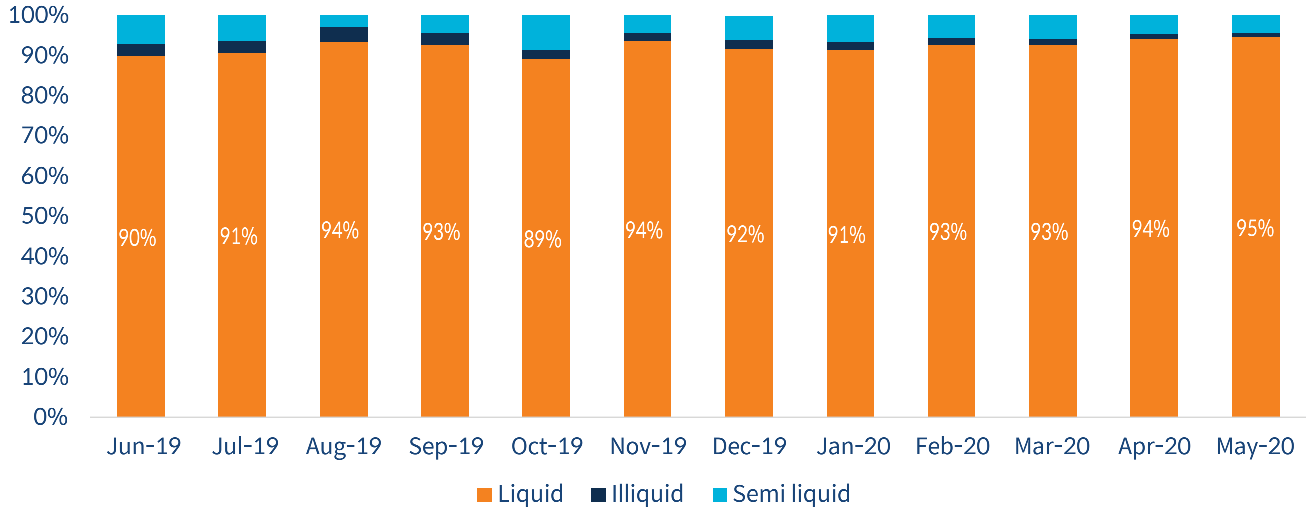
Notes: Others include: Reverse repo, CBLO, TREPS, net receivables, interest rate swaps, repo, call, mutual fund units, fixed deposit and margin.

CRISIL- ranked funds for the quarter ended in March is considered across all categories.

Average exposure of one year ended in May 2020 is considered for analysis.

In addition to a favourable credit profile, the underlying securities of these funds enjoy relatively high liquidity in the bond market, enabling the fund manager to implement portfolio churns. The exposure to liquid securities continued to be high in the last year ended in May 2020, despite underlying fragility in the debt market.

Liquidity profile of Banking and PSU funds



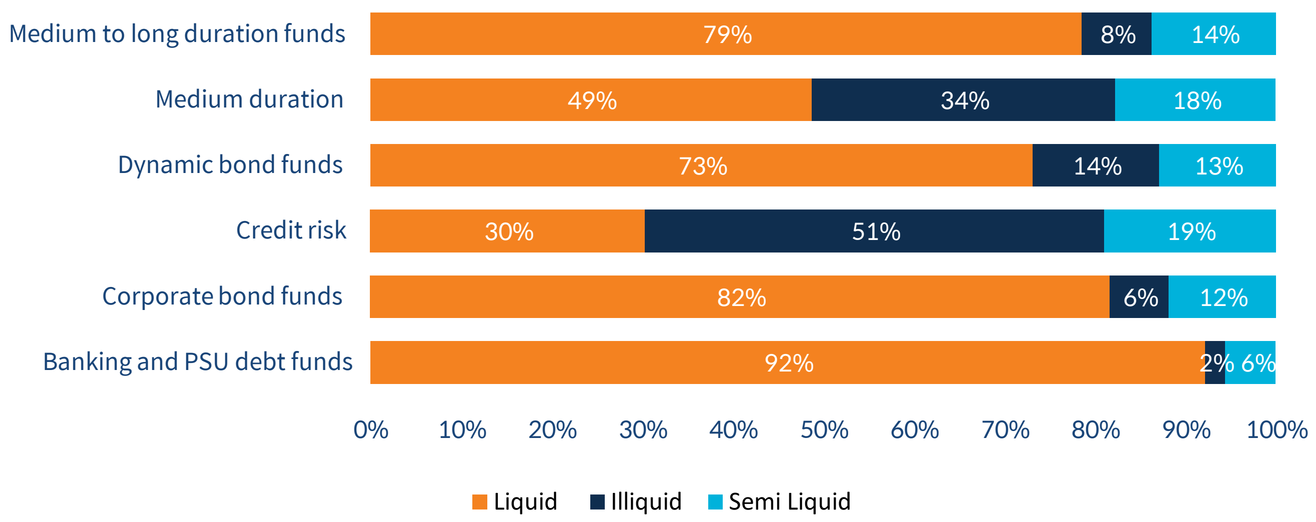
Source: CRISIL Research, Data as on 31st May 2020.

Notes: CRISIL-ranked Banking and PSU funds for the quarter ended March are used for analysis.

Liquidity classification based on CRISIL's internal model that factors trades, volumes and spreads of issuers.

Analysis of the one year ended in May reveals that Banking and PSU funds enjoy the highest average exposure to liquid assets (92%) compared with other debt categories. Liquid assets for corporate bond, credit risk, dynamic bond and medium duration funds ranged 30% to 82%.

Liquidity profile of Banking and PSU funds vis-à-vis other debt categories



Source: CRISIL Research, Data as on 31st May 2020.

Notes: CRISIL-ranked funds for the quarter ended in March 2020 are considered across all categories.

Average exposure of one year ended in May 2020 is considered for analysis.

Liquidity classification based on CRISIL's internal model that factors trades, volumes and spreads of issuers.

Historic performance

The category has shown encouraging performance in recent times despite volatility in the debt market. In the one-year period, these funds have returned 10.96%, the highest across all categories analysed. Additionally, over the medium to long term, the category yielded >8% returns compared with other categories that have mostly lagged behind.

Point-to-point returns across different time frames

Category returns^	6 months	1 year	3 years	5 years	7 years
Banking and PSU debt funds	5.96	10.96	8.13	8.40	8.56
Corporate bond funds	5.85	10.82	7.90	8.40	8.23
Credit risk funds	-4.26	-2.98	0.75	3.85	6.27
Dynamic bond funds	6.20	9.62	6.25	8.06	7.92
Medium duration funds	0.86	4.00	4.36	6.45	7.49
Medium to long duration funds	6.66	10.28	6.20	7.86	7.33

Source: CRISIL Research

Note: ^Average returns of CRISIL-ranked funds for the quarter ended in March across all categories are considered for analysis

Returns for less than one year are absolute and above one year are annualised

Data for the period ended June 17, 2020

Past performance may or may not sustain in future. The data/performance provided above pertains to the category of scheme and does not in any manner constitute performance of any individual scheme of the Fund.

The superior performance of the category in the last one year also came on the back of low volatility and higher risk-adjusted returns. Volatility as measured by standard deviation came in at 1.61% for Banking and PSU funds, lower than most other categories 5.51% (Credit risk funds), 1.58% (Corporate bond funds), 2.63% (Dynamic bond funds), 3.72% (Medium duration funds) and 2.42% (Medium to long duration funds). In terms of risk-adjusted returns, calculated through the Sharpe ratio, Banking and PSU funds got the best ratio of 3.32 vis-à-vis other Debt fund category aggregates.

Risk measures

Risk ratio of categories	Standard deviation	Sharpe ratio
Banking and PSU debt funds	1.61%	3.32
Corporate bond funds	1.58%	3.10
Credit risk funds	5.51%	-0.32
Dynamic bond funds	2.63%	1.87
Medium duration funds	3.72%	0.93
Medium to long duration funds	2.42%	2.20

Source: CRISIL Research.

Notes: CRISIL-ranked funds for the quarter ended March across all categories are considered for analysis.

Risk ratios are six months rolling for the one year ended June 17, 2020.

The risk-free rate is 2.6% for computation of debt schemes' risk ratios.

Tax benefit for investment over three years

Like other debt funds, investment in Banking and PSU funds for a period exceeding three years qualifies for long-term capital gains tax at 20% with indexation. This augurs well for investors in the highest tax bracket as returns from traditional debt instruments such as bank fixed deposits are taxed as per the income tax slab.

Fitment

These funds have certainly become popular in recent times as can be seen in the rise of their AUM, which doubled more than Rs 35,682 crore in April 2019 to Rs 89,945 crore in May 2020. Investors with a low risk appetite looking for relatively safe investment avenue can consider investing in Banking and PSU debt funds over the medium term.

However, notwithstanding all the benefits, these are mark-to-market products and exposed to market risk. A 360-degree analysis of the personal risk-return profile, credit and portfolio attributes of the scheme, the fund house's track record is a must before investing. Investors can get all these details from the factsheet and scheme-related documents hosted on a fund house's website.