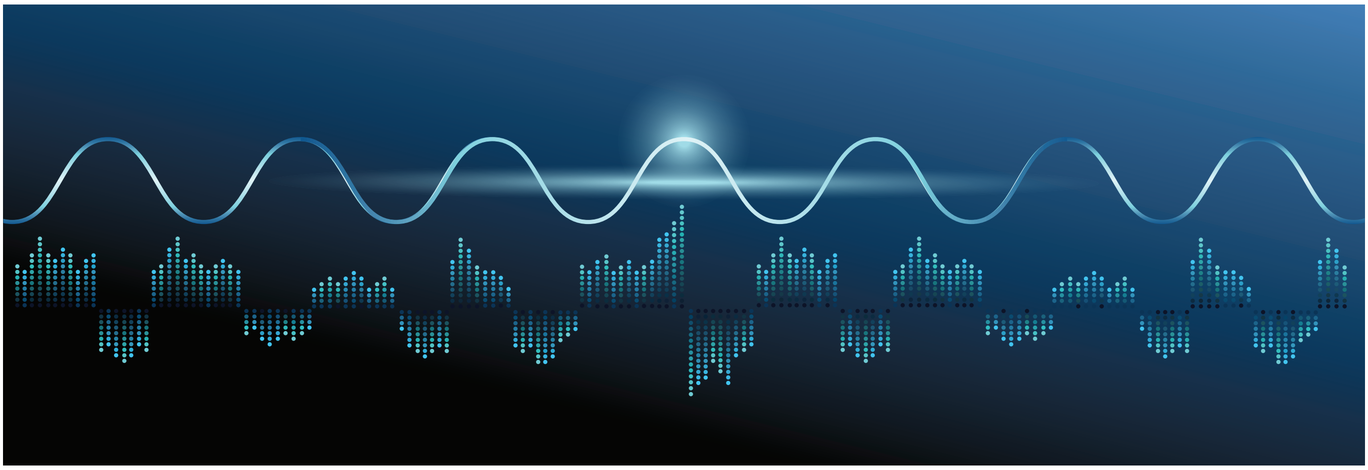
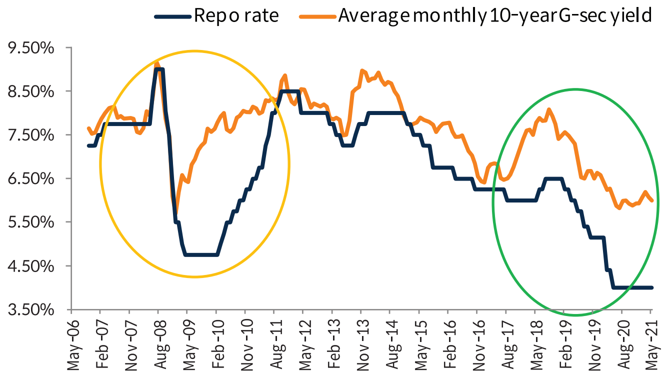
Debt Mutual Funds: An all-weather investment vehicle



The recent rise in domestic and global bond yields hasspooked investorsof debt funds – anincreasein yields leads to a fall in the value of traded bonds, thereby denting fund returns. However, as with any other asset class, debt instruments have their ups and downs;they closely track the interest rate movement. Interest rates have a significantimpact on debt funds based on their yield to maturity (YTM). For instance, long-duration debt funds with higher YTM perform well when interest rates fall, whereas funds that follow accrual strategies to minimise interest rate risk do well during flat and high interest rates.The chart below shows how yields move in tandem with interest rates (repo rates).

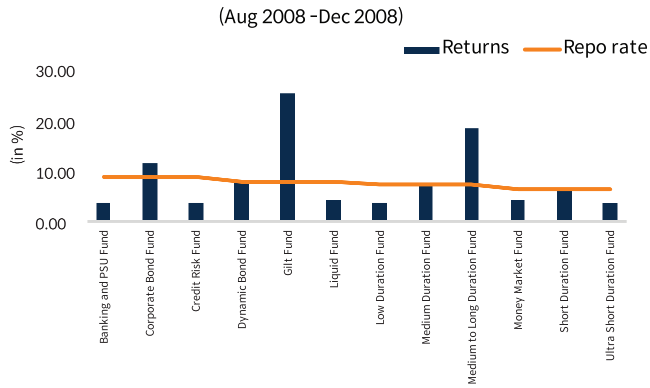
Repo rate vs. Government securities (G-sec) yield movement

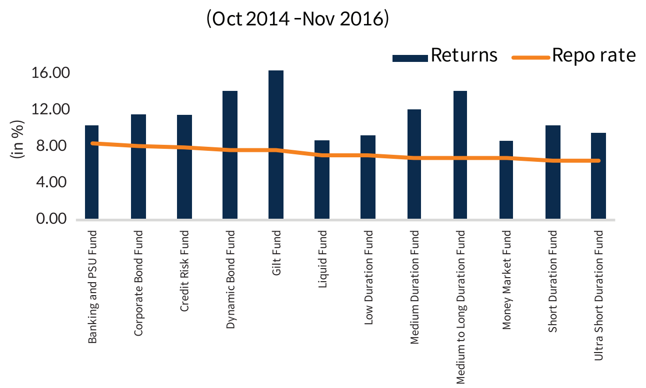


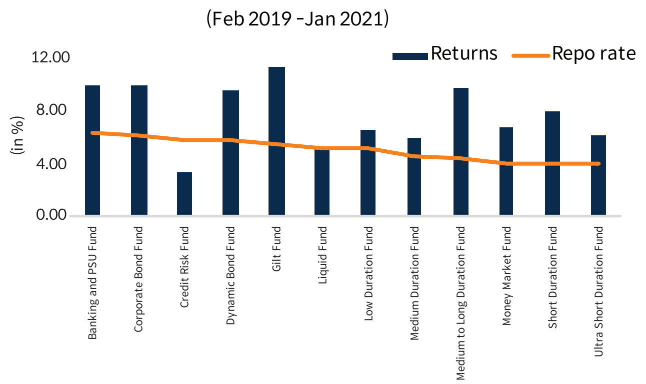
Source: RBI, CRISIL

During the subprime crisis of 2008, interest rates fell steeply, leading to a decline in yields. As a result, longer-duration funds such as gilt funds and medium-to long-duration funds soared during the period. Between December 2016 and January 2019, when yields were up, shorter-maturity funds such as short-duration funds, banking and public sector Undertaking (PSU) debt funds, corporate bond funds, liquid funds, and low-duration funds came up trumps. When interest rates increase, there is a mark-to-market loss as bond yields rise. Short-duration funds benefit by reinvesting the proceeds from the maturity of short-term holdings at a higher prevailing rate.

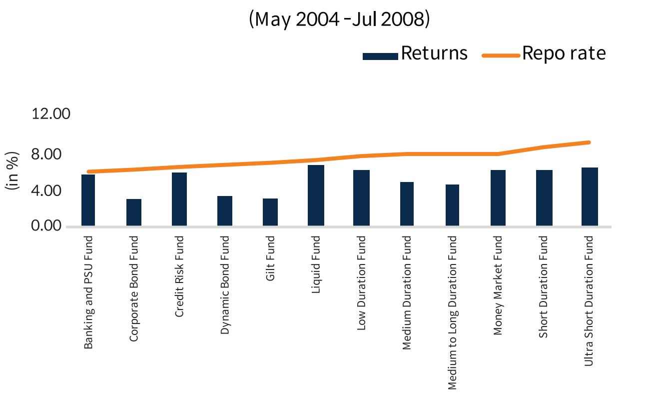
Long-term debt funds benefit during periods of monetary easing

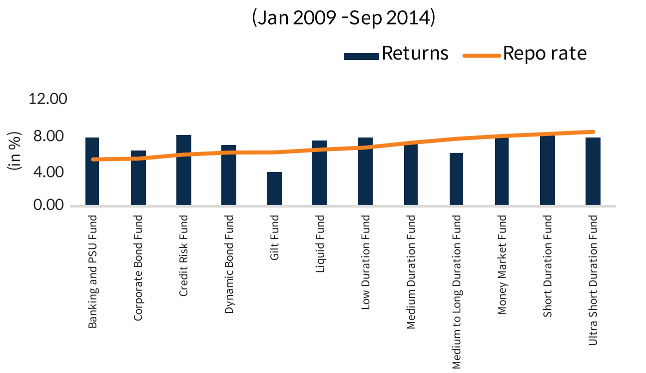


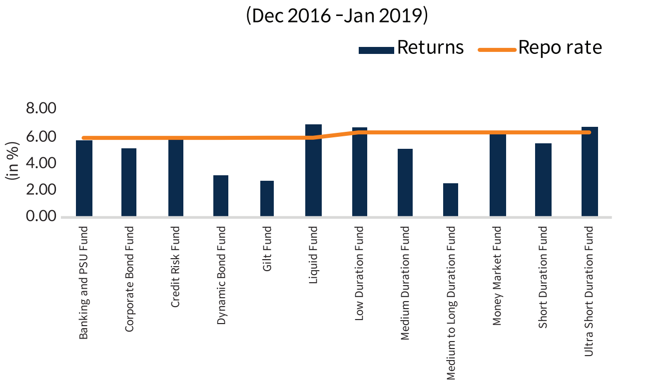




Short-term debt funds gain during periods of rising and flat interest rates







Returns computed by weighted average index of underlying CRISIL-ranked funds of the respective category

Source: CRISIL Research, Past Performance may or may not Sustain in future.

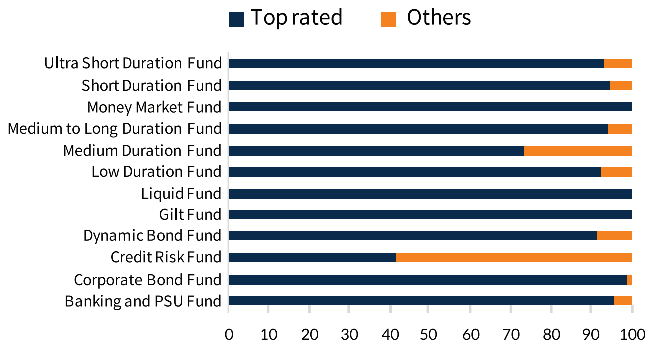
Ride interest rate cycles through debt mutual funds

Even seasoned investors find it difficult to take the right interest rate call. Investors can instead allocate their money to different debt fund categories of varying maturity. For instance, they can look at medium-duration funds such as corporate bond funds, banking and PSU debt funds, and dynamic bond funds. These funds tend to have their maturity profile in between the long and short-duration funds, thus they may provide investors with the benefit of both the worlds. Corporate bond funds invest 80% of their assets in the highest-rated corporate bonds,and may invest a small portion in G-sec. They normally follow the accrual strategy, aiming to generate returns through the accrual of interest on bonds, which are mostly of shorter duration and are held until maturity. As a result, these funds are less exposed to interest rate volatility. Similarly, banking and PSU debt funds invest 80% of their assets in debt instruments of banks, Public Sector Undertaking (PSUs) financial institutions, and municipal bodies. Most of the schemes in these two categories 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. Meanwhile, dynamic bond funds can move across the maturity spectrum, based on the interest rate in the underlying market.

Safety factor in the prevailing market scenario

For investors concerned about the current market scenario, safety of their capital is the priority. Accordingly, analysing the credit quality becomes imperative. As seen in the chart below, various debt fund categories, including banking and PSU debt funds and corporate bond funds, have large exposure to top-rated papers (AAA/A1+ and Government of India securities and treasury bills).

Category-wise rating distribution



Note: CRISIL-ranked funds for the quarter ended March 2021 used for analysis Portfolio as of April 2021. Top rated includes securities rated AAA and A1+; cash and cash equivalents;and government securities/state development loans andtreasury bills Others include papers rated lower than AAA and A1+
Source: CRISIL Research

Systematic Investment Plan (SIP) - the best route to beat volatility

It is difficult for individual investors to take the right call on when to invest as per the interest rate scenarios. Theymight miss most of a market phase, landing up entering or exiting at the fag end of phases and missing superior gains. This is where SIPs can play an important role as regular SIP investments negate the need to time the market across different interest rate environments. Investors also have the opportunity to lower their average cost of investment, known as rupee cost averaging, by investing through SIPs. Further, debt fund SIPs can be used for an investor's financial planning. Considering the anticipated future obligation and time horizon, investors with a low-to-moderate risk appetite can begin SIPs in appropriate categories to meet their goals, as an alternative to recurring bank deposits.

An analysis of monthly SIP returns as of May31, 2021 shows that funds have, on average, provided stable returns for all the periods (one, three, five, and seven years) analysed. If we specifically look at periods of flat and high interest rates, SIP done in debt funds have performed positively, especially shorter duration funds. By investing systematically, investors can benefit from stable returns of debt funds while being disciplined in their investments.

SIP returns across debt fund categories

Period	1 year		3 years		5 years		7 years	
Category	Returns (%)	Value (₹ lakh)	Returns (%)	Value (₹ lakh)	Returns (%)	Value (₹ lakh)	Returns (%)	Value (₹ lakh)
Banking and PSU fund	4.72	1.23	8.04	4.04	7.85	7.27	7.89	11.06
Corporate bond fund	5.21	1.23	8.28	4.05	7.97	7.29	8.01	11.10
Credit risk fund	8.44	1.25	4.84	3.87	4.73	6.78	4.92	10.08
Dynamic bond fund	3.92	1.22	7.34	4.00	6.88	7.11	7.22	10.81
Gilt fund	3.54	1.22	8.35	4.06	7.86	7.27	8.20	11.18
Liquid fund	3.16	1.22	4.49	3.84	5.37	6.84	5.92	10.32
Low-duration fund	4.21	1.22	5.93	3.92	6.24	6.99	6.60	10.57
Medium-duration fund	6.19	1.23	5.60	3.91	5.41	6.88	6.03	10.43
Medium- to long-duration fund	3.65	1.22	7.38	4.00	6.80	7.09	7.08	10.77
Money market fund	3.75	1.22	5.70	3.91	6.23	6.99	6.58	10.56
Short-duration fund	4.72	1.23	7.05	3.98	6.77	7.09	7.00	10.73
Ultra short-duration fund	3.59	1.22	5.22	3.88	5.81	6.92	6.30	10.46

Returns as on May 31, 2021, computed by weighted average index of underlying CRISIL-ranked funds of the respective category SIP of Rs 10,000 per month used in the computation of the growth of the investment amount
Source: CRISIL Research

SIP in debt funds during periods of rising / flat interest rates

Period	May 2004 -Jul 2008		Jan 2009 - Sep-2014		Dec 2016 - Jan 2019	
Category	Returns (%)	Value (₹ lakh)	Returns (%)	Value (₹ lakh)	Returns (%)	Value (₹ lakh)
Banking and PSU fund	5.79	5.75	7.16	8.62	6.45	2.78
Corporate bond fund	3.39	5.49	7.74	8.75	6.13	2.77
Credit risk fund	6.09	5.78	8.74	9.00	5.51	2.75
Dynamic bond fund	3.95	5.54	8.03	8.82	4.69	2.73
Gilt fund	4.58	5.61	7.31	8.64	5.18	2.74
Liquid fund	7.45	5.95	8.37	8.91	7.22	2.80
Low-duration fund	7.05	5.90	8.63	8.59	7.11	2.80
Medium-duration fund	5.58	5.73	7.88	8.78	5.44	2.75
Medium- to long-duration fund	5.65	5.73	7.44	8.67	4.23	2.72
Money market fund	6.91	5.88	8.58	8.96	6.87	2.79
Short-duration fund	6.97	5.89	8.62	8.84	5.94	2.76
Ultra short-duration fund	7.00	5.89	8.62	8.97	7.03	2.79

Returns computed by weighted average index of underlying CRISIL-ranked funds of the respective category SIP of Rs 10,000 per month used in the computation of the growth of the investment amount
Source: CRISIL Research

Summing up

It is a misconception that investors can benefit from debt mutual funds only in a falling interest rate scenario. They can select funds from the various debt fund categories as per their risk profiles and goals to create a diversified portfolio, which could create wealth in different interest rate environments. Further, debt SIPs can be considered for disciplined investing and removing the stress of timing the market.