Banking and PSU Funds

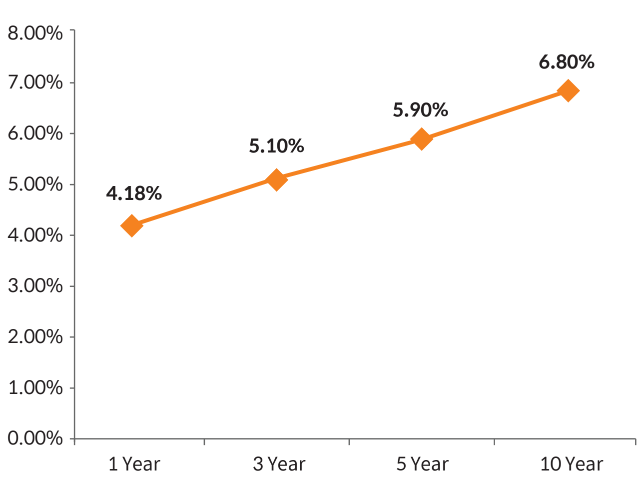
What are Banking and PSU Funds?

Banking and PSU Funds are debt mutual fund schemes which invest in debt and money market instruments issued by banks, Public Sector Undertaking (PSU) and Public Financial Institutions (PFI). As per SEBI's mutual fund classification guidelines, Banking and PSU Funds must invest at least 80% of their assets in instruments issued by such institutions.

How do Banking and PSU Funds work?

- The yields of Banking and PSU Funds depend on the interest rate environment and the prevailing credit spreads. Yield of debt and money market securities usually increases with maturity or duration (see the AAA rated Corporate Bond yield curve below). Unlike several debt fund categories, SEBI does not have duration limits for Banking and PSU Funds. The fund managers have the flexibility to invest in durations which are attractive from a yield perspective.

AAA rated Corporate Bond Yield Curve



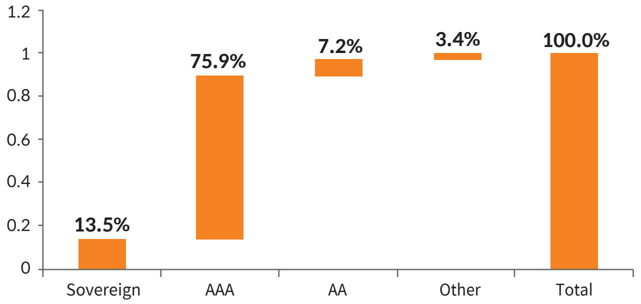
Source: CRISIL, 30th April 2021

- The fund managers of Banking and PSU Funds also take active duration calls depending on their interest outlook. If the interest rate outlook is favourable then Banking and PSU Funds may lengthen their durations and vice versa. Prices of fixed income securities are inversely related to interest rate changes. Longer the duration of a debt instrument, the more sensitive it is to interest rate changes. The returns of a debt scheme with longer duration will be higher compared to scheme of shorter duration. If the interest rate outlook is not favourable, the fund managers may shorten the duration of the scheme.

Credit risk

Debt and money market instruments issued by Banks, PSUs and PFI are usually of high credit quality. PSUs and some of the PFIs are Government owned entities. These debt and money market securities enjoy quasi sovereign status. As such their credit risk is very low. Banks and PFIs (both public sector and private sector) enjoy high credit rating because they are regulated entities and are usually adequately capitalized. Investors should also know that many banks are owned by the Government (known as PSU Banks). The chart below shows the average credit rating breakdown in Banking and PSU fund category (average of all the funds), as on 30th April 2021. You can see that the average credit quality of Banking and PSU funds is quite high.

Credit rating profile of Banking and PSU Funds (Category Average)



Source: Advisorkhoj Research, 30th April 2021

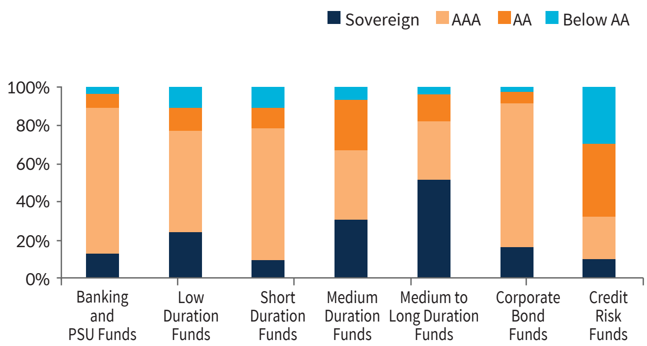
Why is credit quality important?

Yields of debt and money market securities are related to their credit rating. Lower rated papers give higher yields than higher rated papers. Some debt funds may invest in lower rated papers to capture higher yields, but investors must be aware of credit risks involved. If the issuer of debt security defaults on interest (coupon) or principal (maturity), then the value of security is written down as per SEBI Regulations. This may result in permanent reduction of the Net Asset Value (NAV) of the scheme – loss for the investors. Some mutual fund schemes may segregate their bad assets in a separate portfolio and try to recover the money from the issuer, but it may take a very long period of time for investors to recover their losses, if they are recovered at all.

Superior credit quality compared to many debt categories

The chart below shows the credit quality profiles of some debt fund categories. You can see that the credit quality of Banking and PSU Funds is superior compared to most categories. The quasi sovereign (PSU) status of the underlying securities of these schemes lends further strength to the quality of the schemes.

Credit rating profile of Banking and PSU Funds versus other fund categories

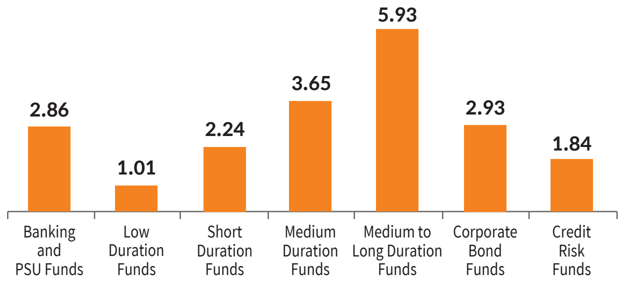


Source: Advisorkhoj Research, 30th April 2021

Interest Rate risk

Banking and PSU funds have the flexibility to invest across durations. These funds manage interest rate risk by taking active duration calls. If the interest rate outlook is not favourable then Banking and PSU Funds shorten their duration profiles. The chart below shows the average maturities of different debt fund categories. You can see that interest rate risk of Banking and PSU funds is higher than short and low duration funds, but lesser than the longer duration funds.

Average Maturities (years) profile of Banking and PSU Funds versus other fund categories

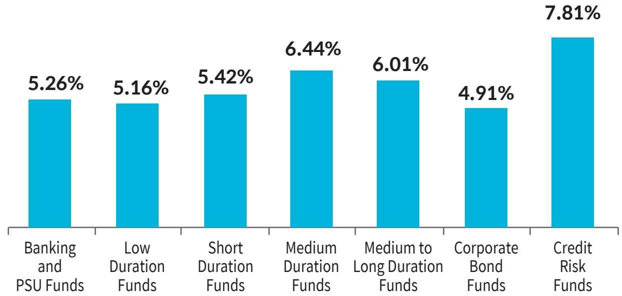


Source: Advisorkhoj Research, 30th April 2021

Yield to Maturity

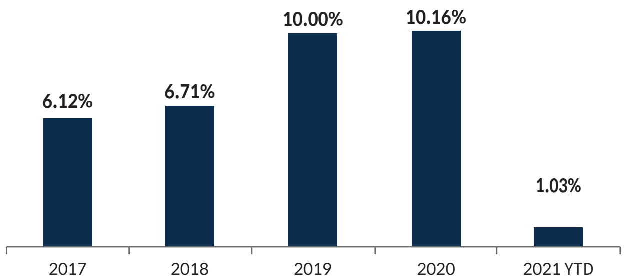
As mentioned earlier, Banking and PSU Funds try to invest in attractive yields depending on the interest rate environment. The chart below shows the average Yield To Maturities (YTM) of different debt fund categories. You should consider risk (interest rate and credit risks) and return (yields) trade-off and make informed investment decisions.

YTM profile of Banking and PSU Funds versus other fund categories



Source: Advisorkhoj Research, 30th April 2021

Annual Category Average Returns – Banking and PSU funds



Source: Advisorkhoj Research, 17th May 2021

The returns are average of total number of funds existing in the respective years.
The returns are for regular growth plan.

Past performance may or may not be sustained in the future.

Taxation of Banking and PSU Funds

If your investment tenure is less than 3 years, the capital gains will be added to your income and taxed according to the applicable income tax slab rate. Long term capital gains (investment holding period of 3 years or longer) will be taxed at 20% after allowing for indexation benefits. Dividends (Known as Income Distribution cum Withdrawal) paid by Banking and PSU Funds will be added to your income and taxed as per your income tax rate.

Why to invest in Banking and PSU Debt Funds now?

US Treasury bonds are still low as the US Federal Reserve is still holding interest rate at near zero and continuing its bond buying programme. But there are indications that the Fed will start tapering its accommodative monetary policy as the US economy shows further signs of recovery. As US economic data improves, Fed's focus will shift from growth to inflation. Consequently, US Interest Rates and Treasury bond yields are likely to go up in the near to medium term.

This will have an impact on Indian G-Sec yields. The 10 year G-Sec yield is near its 10 year low and will start going up at one point of time. Bond prices have an inverse relationship with yields. As yields go up bond prices come down. Longer duration bonds are more sensitive to interest rate changes than shorter term bonds. Banking and PSU Funds have the flexibility to invest across durations. The funds take active duration calls based on their interest rate outlook. If interest rates are expected to go up, Banking and PSU funds shorten their duration to reduce interest rate risks. They invest in durations where credit spreads are attractive while managing risk / return trade-off. Further Banking and PSU funds have low credit risk as the issuers of the underlying securities of these schemes enjoy superior credit ratings. As such, Banking and PSU Funds are suitable for investors with 3 years or longer investment tenures in the current macro environment.

Who should invest?

- Investors who are primarily looking for income and also capital appreciation in favourable interest rate environment.
- Investors with moderate risk appetites.
- Investors are prepared to remain invested for at least 3 years.
- Investors should consult with their financial advisors if Banking and PSU Funds are suitable for their investment needs.