MIRAE ASSET Mutual Fund

Dynamic Bond Funds

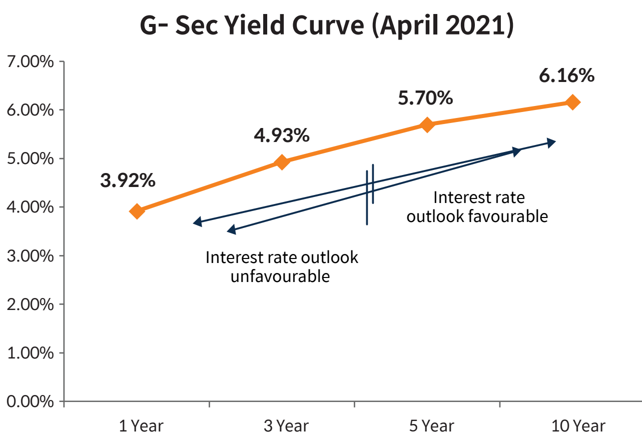
What are Dynamic Bond Funds?

Dynamic Bond Funds are fixed income mutual fund schemes which invest in debt and money market securities across durations.

How do Dynamic Bond Funds work?

Dynamic Bond Funds can generate returns from two sources – income from interest (yield) paid by the bonds and price appreciation of bonds if interest rates fall. Bond yields usually increase with bond maturity – see the yield curve below. However, the interest rate risk increases with duration of the bond. Fund managers of these schemes take duration calls depending on their interest rate outlook. If they expect interest rates to fall in the future, then they invest in longer duration bond. If fund managers expect interest rates to rise in the future, then they invest in shorter duration bonds and re-invest the maturity proceeds in higher yielding bonds in the future.

G- Sec Yield Curve (April 2021)



Source: RBI, 30th April 2021.

Disclaimer: The chart above is purely for illustrative purposes and should not be construed as investment recommendation.

How Dynamic Bond Funds manage risk?

Prices of fixed income securities are inversely related to interest rate changes. If interest rate goes up, price decreases and vice versa. The interest rate risk of a fixed income fund depends on the duration profile of the fund. Funds of longer duration profiles have higher interest rate risk and vice versa. The fund managers of Dynamic Bond Funds have the flexibility to manage interest rate risk by investing in bonds across durations.

If they expect interest rates to go down, Dynamic Bond Funds invest in longer duration bonds. Longer duration not only give higher yields, but they also give higher price appreciation if interest rates fall. Let us assume a bond with 5 year duration has a yield of 7%. If interest rate falls by 0.5 bps in one year, then return of the bond will be = 7% (yield) + 5 X 0.5% (price appreciation) = 9.5%. However, if the fund manager expects interest rates to rise in the future then they invest in shorter duration bonds. Let us assume that the fund manager invests in a bond of 3 year duration with yield of 6%. If interest rate rises by 0.5 bps, then return of the bond will be = 6% (yield) – 3 X 0.5% (price appreciation) = 4.5%. Though returns are lower, the fund is able to reduce volatility considerably by taking active duration calls.

Credit risk

The credit risk of Dynamic Bond Funds depends on the quality of the underlying portfolio. Yields of fixed income securities depend on the credit rating of the securities. Lower rated papers give higher yields than higher rated papers. Lower rated papers have higher chance of credit rating downgrade or default. You should check the credit quality of the fund in the fund factsheet before investing.

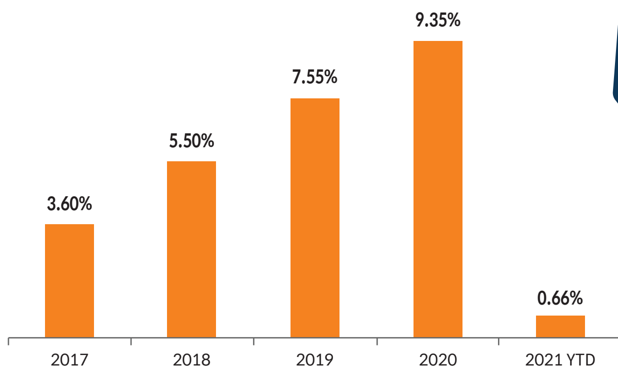
Benefits of Dynamic Bond Funds

- Dynamic Bond Funds have the potential of giving higher returns than shorter duration funds. Shorter duration funds are restricted by duration mandates i.e. their duration profiles cannot exceed the duration limits specified by SEBI for each category. Dynamic Bond Funds on the other hand have the flexibility to invest in longer duration bonds (higher yields and potential price appreciation) depending on the fund manager's interest rate outlook.
- The flexibility of Dynamic Bond Funds to invest across durations gives it the ability to manage downside risks to a greater degree compared to long duration funds and Gilt funds which cannot reduce duration below the limit specified by SEBI for these categories. As such, Dynamic Bond Funds are less volatile than longer duration funds in unfavourable interest rate scenarios.
- Dynamic Bond Funds aim to generate returns with relatively lower volatility for investors in all interest rate scenarios.

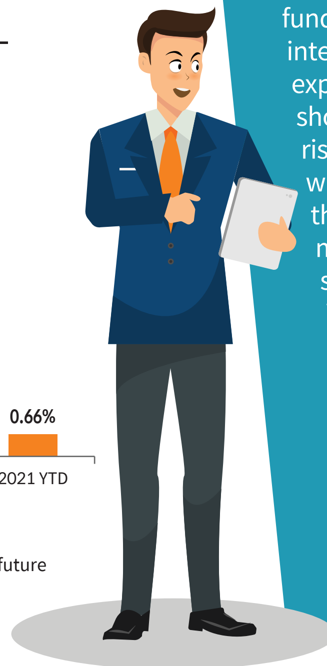
Taxation of Dynamic Bond Funds

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 paid by Dynamic Bond Funds will be added to your income and taxed as per your income tax rate.

Annual Category Average Returns – Dynamic Bond Funds



Source: Advisorkhoj Research (as on 12th May 2021).
Disclaimer: Past performance may or may not be sustained in the future



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 Dynamic Bond Funds are suitable for them.

Why to invest in Dynamic Bond 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. Dynamic Bond 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, Dynamic Bond Funds shorten their duration to reduce interest rate risks. If interest rates rise, Dynamic Bond Funds will be able re-invest the maturity proceeds of their debt or money market securities maturing in the near term at higher yields. As such, Dynamic Bond Funds are suitable for investors in the current interest rate situation. However, since these schemes may have moderate sensitivity to interest rates, investors should have minimum 3 year investment tenures for these schemes. Over 3 years plus investment tenures, investors can also enjoy the benefits of long term capital gains taxation.

An investor education initiative by Mirae Asset Mutual Fund.

All Mutual Fund investors have to go through a one-time KYC (Know Your Customer) process. Investors should deal only with Registered Mutual Funds (RMF). For further information on KYC, RMFs and procedure to lodge a complaint in case of any grievance, you may refer the Knowledge Center section available on the website of Mirae Asset Mutual Fund.

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully.