Make place for debt funds in your portfolio

Mirae Asset Knowledge Academy
Profit from Knowledge

The equity market's stellar performance has beckoned many investor to take huge exposure to the asset class. Though equity is one of the best wealth creators in the long term, it is prudent to include a less risky asset class such as debt to balance the investment portfolio. While mutual funds have emerged as a preferred platform for investing in equity, debt investments are still largely restricted to traditional avenues such as banks fixed deposits (FDs) and savings accounts. Investors must shun their traditional bias and consider debt mutual funds as well to enhance returns.

Debt funds have something for everyone

Debt funds offer many options to investors as per their needs, horizon and risk profile. Broadly, these funds follow the accrual or duration strategy. Accrual-based funds focus on generating interest income from bonds' coupon and mostly hold bonds until their maturity. Liquid, ultra-short term, short-term debt and corporate bond funds follow an accrual strategy. As they are short-tenured, they are less sensitive to interest rate changes. Credit funds, however, are riskier as they are exposed to the credit risk. Duration-based funds, in contrast, focus more on capital appreciation by taking interest rate calls and benefit from decline in interest rates.

Investors can choose a fund based on three main parameters: liquidity, safety and returns. For instance, investors who want to keep an emergency amount aside can invest in liquid funds instead of a savings account as the former has the potential to generate high returns at reasonable liquidity. Similarly, those who want to enhance their returns on debt can explore income and gilt funds as they seek to generate higher yield based on the underlying interest rate cycle.

Fund Type	Suitability in terms of goals	Risk/Returns	Strategy	Features
Ideal in a rising/high interest rate scenario				
Liquid funds	Short term	Low	Accrual	• Invest in money market instruments • Alternative to savings bank account
Ultra short-term debt funds	Short term	Low	Accrual	• Have higher portfolio maturity than liquid funds • Better returns and comparatively risker than liquid funds
Short-term income funds	Short to medium term	Moderate	Accrual	• Less sensitive to interest rate changes • Benefit more in when interest rates rise
Ideal in a falling interest rate scenario				
Long-term income funds	Medium to long term	High	Duration	• Benefit when interest rates fall, as bond prices & interest rates are inversely correlated • Invest in long-term bonds
Gilt funds	Medium to long term	High	Duration	• Invest only in government issued bonds • No credit risk but expose to interest rate risk
During an uncertain interest rate scenario				
Dynamic bond fund	Medium to long term	Moderate	Duration	• Offers flexibility to alter the portfolio maturity according to the interest rate scenario • Less risky than income and gilt funds
For higher yields				
Credit funds (corporate bond funds/credit opportunity funds)	Short to medium term	High	Accrual	• Invest in bonds issued by corporates to earn higher yield • Highly exposed to credit risk

For representation purpose only

Debt funds offer opportunity to earn market-linked returns

Debt funds are market-linked and invest in diverse debt instruments such as government securities, corporate bonds and money market instruments. Active management of various debt securities by a professional fund manager aims to generate potentially higher returns than FDs and savings account.

Performance (%)	1 year	3 Years	5 years	7 years	10 Years
Income funds	6.64	10.05	8.70	8.63	8.59
Gilt funds	7.14	11.46	9.45	8.69	8.24
3-year banks' FD index	8.12	8.70	8.82	8.66	8.38
ST debt funds	7.47	8.99	8.85	8.83	8.38
UST debt funds	7.39	8.33	8.63	8.67	8.09
Liquid funds	6.65	7.71	8.26	8.35	7.75
1-year banks' FD index	7.40	8.18	8.53	8.39	8.08
Savings banks' account	3.92	3.98	3.99	3.95	3.82

Past Performance may or may not sustained in future. Debt fund categories represented by respective CRISIL-AMFI debt performance indices. Annualised returns as of September 29, 2017. Source: CRISIL Ratings, 2017.

Indexation benefit

Debt mutual funds can help investors earn higher tax-adjusted returns vis-à-vis traditional products for a holding period of more than three years owning to the benefit of indexation. For instance, investors in, say, income funds would have earned higher tax-adjusted annualised returns of 8.94% compared with annualised 6.24% returns in case of FDs in past three years ended September 29, 2017 owing to the indexation benefit as tabled below.

	Income Fund	Bank FD
A. Initial investment	100,000	100,000
B. Value at end of 3rd year	133,282	128,437
C. Pre-tax returns	10.05%	8.70%
D. Indexed value based on CII	113,333	-
E. Taxable amount (B - D)	19,948	28,437
F. Tax payable	3,990*	8,531
G. Post tax returns	8.94%	6.24%

Past Performance may or may not sustained in future. Data as of three years ended September 29, 2017. Income fund and bank FD represented by CRISIL-AMFI Income fund performance index and 3-year bank FD index respectively. Assuming highest tax bracket of 30%. * Taxed at 20% after providing indexation CII (cost inflation index)

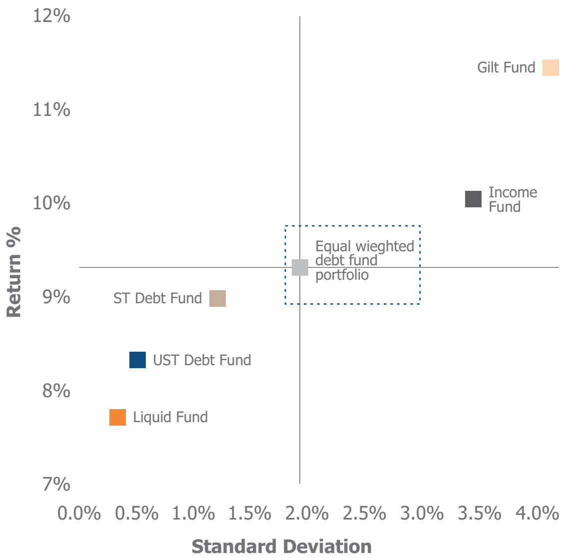
Strategies of managing risk in debt funds

As these funds are market-linked they are exposed to interest, credit and liquidity risks. However, investors can use the following strategies to efficiently manage the risks.

Regular investing : While it is well known that regular investing helps to iron out volatility, systematic investment plans (SIPs) are mostly used in equity funds. SIPs can also be used in debt funds just like bank recurring deposits. This is because performance of some funds such as income & gilt, and credit funds can be volatile at times as they are sensitive to interest and credit risks, respectively. Timing of investment plays an important role in generating returns as the economy typically follows interest rate and credit cycles. For instance, performance of income and gilt funds in a rising or uncertain interest rate environment can be very volatile. Likewise, credit funds are typically risky in an economic downtrend when rating downgrade of bonds is common. Hence, SIP in these funds will not only reduce volatility, but also negate the need for timing.

Diversify across debt funds to meet goals : All debt fund categories have a peculiar risk-return proposition and, hence, it is prudent for investors to diversify among debt fund categories to meet investment goals and earn optimum risk-adjusted returns. Consider this - diversifying investment equally among different categories has given optimum returns with lower risk compared with only gilt or income fund as seen in the beside chart. However, investors should allocate among various debt fund categories based on their risk profile.

Risk-return matrix



Past Performance may not sustained in future. Debt fund categories represented by respective CRISIL-AMFI debt performance indices. Based on three-year data as on 29th Sep'2017. For representation purpose only. Source: CRISIL Ratings, 2017.

Summing up

Thus, given the potential to generate better market-linked returns with reasonable safety and liquidity, debt funds have emerged as an essential element of an investor's asset allocation plan. And while they are exposed to interest, credit and liquidity risks, investors can choose from a range of debt funds to suit their risk-return profile and investment goals.

Email Us customercare@miraeasset.com

Call Us 1800-2090-777 (Toll Free) Mon-Sat: 9 a.m. to 6 p.m.

Internet www.miraeassetmf.co.in

Contact your financial advisor for details