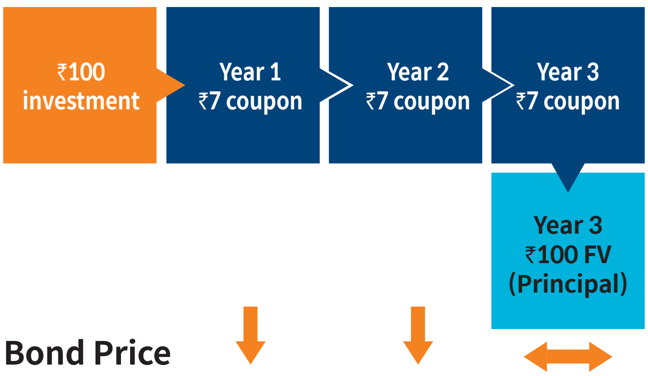
Short Duration Fund

What are Short Duration Funds?

Short Duration Funds are fixed income mutual fund schemes which invest such that the Macaulay Duration of the scheme is 1 to 3 years. Macaulay duration is the weighted average of the period the investor should remain invested in the security in order to have the present value of the cash flows (interest and principal payments) from the bond match the amount paid for the bond. Longer the maturity of a bond, longer is its Macaulay Duration.

How do Short Duration Funds work?

The primary investment objective of Short Duration Funds is to generate income through accrual of bond yields over the maturity term of the instruments in the scheme portfolio. These funds aim to hold the securities (G-Secs, corporate bonds, CPs, CDs etc) till maturity. If bonds are held till maturity, then price volatility has no impact on the final returns. Let us understand this with the help of an example. Suppose you buy a bond of ₹100 face value, which pays 7% annual coupons (interest) and matures in three years. You pay ₹100 for the bond. The cash-flows of the bond will be as follows:



Disclaimer: Above diagram is purely illustrative and should not be construed as investment recommendation

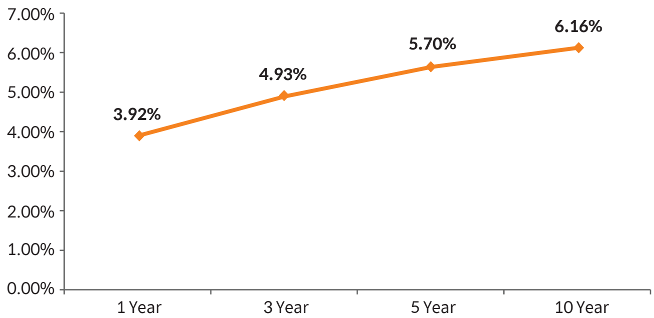
The bond price may fluctuate (fall if interest rate rises and vice versa) with changes in interest rates, but if you hold the bond till maturity you will get the cash-flows as described above. The internal rate of returns of these cash-flows is known as Yield to Maturity (YTM). Therefore, in the above example the YTM of the bond is 7%. This is the annualized return you will get if the bond is held till maturity and interest rate changes will have no effect on your return.

Returns of Short Duration Funds

The primary source of returns of Short Duration Funds is yield of the underlying securities over the investment tenure. The yield of Short Duration Funds depends on two factors – duration and credit quality.

Yield of debt and money market securities usually increases with duration (see the yield curve below. Since the Macaulay Durations of these funds are between 1 and 3 years, their yields are lower compared to longer duration funds (e.g. medium duration fund, long duration funds, Gilt funds etc). However, yields of Short Duration Funds are higher than shorter duration funds (e.g. liquid funds, ultra-Short Duration Funds, low duration funds, money market funds etc.)

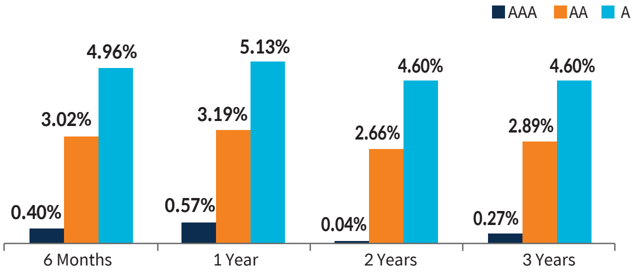
G- Sec Yield Curve (April 2021)



Source: RBI, 30th April 2021

The yields of Short Duration Funds also depend on the credit quality of the underlying securities. Lower rated securities give higher yields than higher rated securities (see the chart below). However, risk of loss arising out of non payment of interest or principal is higher in lower rated securities.

Credit Spreads - Spreads of Corporate Bond Yields over G-Secs



Source: RBI, 30th April 2021

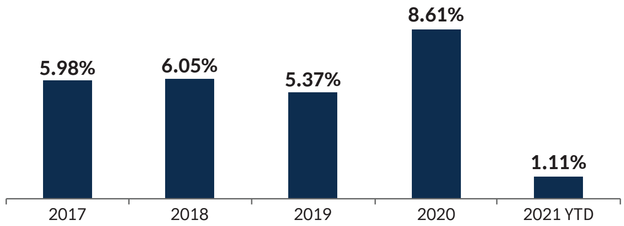
Risks of Short Duration Funds

- **Interest rate risk:** Interest rate risk depends on the duration profile of the fund. Since Short Duration Funds have Macaulay Durations of 1 to 3 years, the interest rate risk is moderate. Interest rate risk of these funds is lower than longer duration funds (e.g. medium duration fund, long duration funds, Gilt funds etc). However, the interest rate of Short Duration Funds is higher than shorter duration funds (e.g. liquid funds, ultra-Short Duration Funds, low duration funds, money market funds etc.). You should invest according to your risk appetite.
- **Credit risk:** Credit risk of dynamic bond funds depends on the quality of the underlying portfolio. Lower rated papers have higher chance of credit rating downgrade or default. Credit rating downgrade or default can result in a permanent loss. You should check the credit quality of the fund from the fund factsheet before investing.

Taxation of Short Duration 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 indexation benefits.

Annual Category Average Returns – Short Duration 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.
- Investors with moderate risk appetites.
- Investors should ensure that their investment tenures matches or exceeds the average maturity of the scheme portfolio.
- Investors who want to benefit from indexation in long term capital gains taxation for investment tenures over 3 years.
- Investors should consult with their financial advisors if Short Duration Funds are suitable for their investment needs.

Why Invest in Short Term 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. Short term funds invest in debt and money market securities such that the Macaulay Duration of the scheme portfolio is between 1 to 3 years. Since the duration of these schemes is fairly low, interest rate (yield) increases will have limited effect on the scheme Net Asset Values. Short term funds hold the securities in their portfolio till maturity and accrue the yields. These funds also try to invest in durations (in the 1 to 3 year range) where credit spreads are attractive. As such, Short Term Funds are suitable for investors with 2 to 3 years or longer investment tenures in the current macro environment.

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.