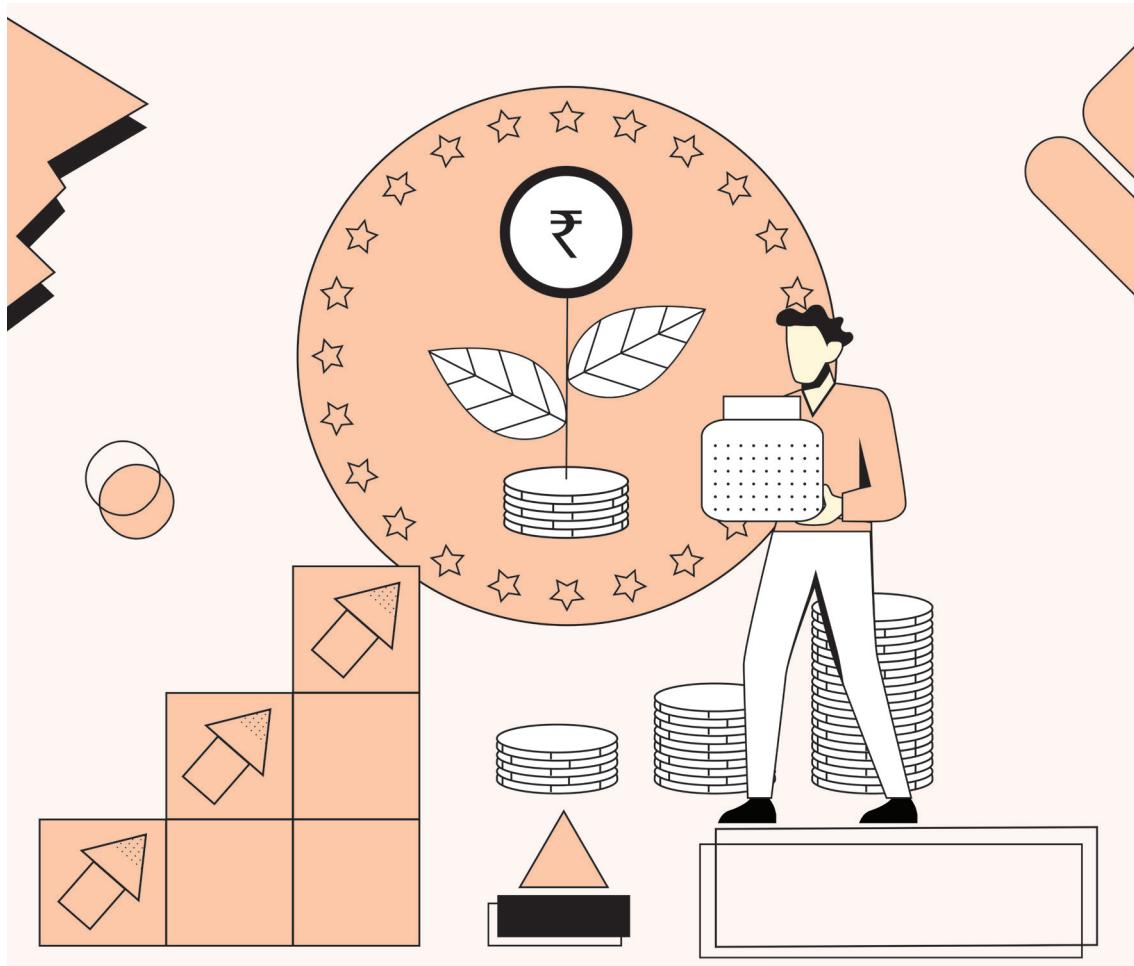


THE SCIENCE OF INVESTING IN DEBT FUNDS

How to pick debt funds that don't fail you



Since the IL&FS episode in 2018, the debt-fund industry has seen a lot. Heightened risk aversion in the aftermath of IL&FS and ensuing funding issues unleashed a series of downgrades, defaults and even segregations in the portfolios of debt funds. These were not limited to riskier categories but also impacted categories normally perceived as safe, such as low-duration funds and short-duration funds. The winding-up of six debt schemes by Franklin Templeton in the mid-2020 was quite a prominent tragedy in this saga.

Although the fund house has now returned most of the investors' money, the Franklin episode struck investors at a time when they were still trying to make sense of what's wrong with debt funds. Until a couple of years ago, they were deemed as safe as bank deposits, gave good returns and kept investors happy. However, post-2018, one frequently hears about this debt fund registering a drop in its NAV and that debt fund writing off its investment in a bond. Obviously, such incidents unnerve investors.

Here we will revisit the basics of investing in debt funds so that you can still pick winning debt funds and avoid the ones that can destroy your capital. At the outset, it's worth mentioning that recurring incidents in debt funds shouldn't be seen as some

industry-wide problem. Neither should you dismiss debt funds as unworthy investments. Good debt funds have not just been able to weather such storms but also given returns better than bank FDs. With their favourable taxation, they have saved even more for their investors. All that you need to do now is to be more cognizant of the risks in debt funds, as you are in the case of equity funds.



Why you should invest in debt funds

Debt funds add value to an investor's portfolio with their promise of reasonably better returns over bank deposits and liquidity too.

Also as stated earlier, debt funds are more tax-friendly than bank deposits. When you invest in a debt fund, you need to pay tax only when you sell. Till then, your returns keep accumulating. In the case of FDs, you will have to pay tax on the interest accrued every year. If you sell a debt fund within three years of purchasing it, you have to pay

tax as per your slab rate. If you sell after three years, you have to pay a tax of 20 per cent post indexation. Indexation, which means adjusting your gains against inflation, lowers your tax outgo.

Key risks in debt funds

Debt funds come in various forms. There are as many as 16 types. Within the same type, there could be different styles of management, which can increase or decrease your risk. At Value Research, we have always advised that you shouldn't get venturesome with your debt funds. While you do want higher returns than bank deposits when you invest in debt funds, you should also balance the corresponding risk. If you want to take risk for larger gains, then you should invest in equity.

The reason Franklin Templeton had to wind up six of its schemes was that the fund house bet on lower-rated bonds to pump returns. Amidst the COVID-19 crisis, due to reduced liquidity in the debt market, the fund house found it difficult to sell its lower-rated papers to meet redemptions. Eventually, it decided to shutter its affected schemes in April 2020.

Hence, when you pick a debt fund, you must analyse its holdings to assess the risks involved. Let's see what these are.

Credit risk

Credit risk means the possibility that issuer of a bond may default on the interest or principal payment. Based on the repaying ability of borrowers, credit-rating agencies assign ratings to debt instruments. The higher the rating, the higher the probability the borrower will pay up. For instance, an 'AAA' rated bond has a high degree of safety. On the other hand, a 'D' rated one has a high probability of default.

Historically, as interest rates have headed south, debt funds have taken exposures to lower-rated papers. As seen in the graph titled 'In search of yields', since 2012, interest rates have largely been down-trending and simultaneously there has been a rise in allocation to instruments that are rated AA and below. However, amidst the pandemic, risk aversion led funds to revert back to high-quality bonds. Having said that, once the tides turn and the economy revives, there is a possibility that many funds will start taking credit risk again. As an investor, you should factor in this aspect while taking investment decisions.

How fund managers mitigate credit risk

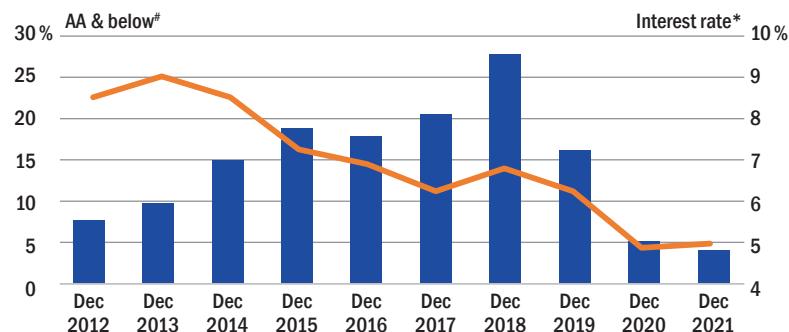
Besides using the ratings of credit-rating agencies, AMCs have dedicated teams to do

their own credit assessment. They also monitor the holdings regularly and diversify them across issuers. Since AMCs lend on a larger scale, they also have the ability to demand collateral against riskier lending. They also check if the

borrower is indeed using the money for the stated purpose. Despite all these, accidents do happen, as seen in the case of IL&FS, which was rated AAA. Economy also has a part to play in defaults. In challenging times, defaults tend to rise.

In search of yields

Given the risk aversion amidst the pandemic, most debt funds cleaned up their portfolios. However, historically, falling interest rates in the economy have nudged debt funds to invest in lower-rated papers to enhance their yields.

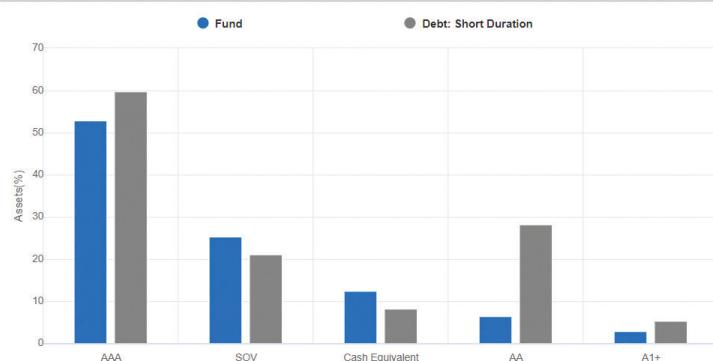


#Excludes FMPs, overnight and liquid funds, *SBI's one-year FD rate for the corresponding date

Portfolio break-up on the Value Research website

The fund page on the Value Research website captures the credit profile of debt funds, which helps you assess the credit risk a fund is assuming

Credit Rating vis-à-vis Category



Top Holdings

Company	Instrument	Credit Rating	1Y Range	% Assets
▲ 7.27% GOI 2026	GOI Securities	SOV	0.00 - 11.72	11.72
↔ 8.10% NTPC 27/05/2021	Bonds	AAA	6.53 - 11.35	7.64
▲ 6.18% GOI 2024	GOI Securities	SOV	0.00 - 7.63	7.63
↔ 7.57% Ultratech Cement 2021	Debenture	AAA	0.00 - 6.81	6.81
↔ 7.00% Reliance Industries 31/08/2022	Non Convertible Debenture	AAA	4.74 - 9.09	5.59

How you can reduce credit risk

This risk is relatively easier to deal with. All you need to do is avoid funds that assume too much credit risk. In almost all categories of debt funds, there are plenty of options that maintain a high-quality portfolio. For this, you can use the credit rating break-up of any debt fund at the Value Research website (see a sample screenshot, 'Portfolio break-up on the Value Research website'). Periodically monitor the portfolio of your debt scheme. If there is a rise in allocation to lower-rated papers, dig deeper.

Interest-rate risk

Also called the duration risk, this is the risk of a sudden drop in the NAV of your debt fund due to a rise in interest rates. In India, the RBI sets interest rates depending upon the ongoing inflation rate and economic outlook. If it increases the interest rate, any new bond issuances will have to offer higher interest. This would make the existing bonds in the market relatively less attractive due to their lower interest rates and therefore their prices would fall to adjust for their lower payouts.

The further the maturity of a bond, the greater would be the fall in its price when the interest rates rise. Thus, funds with long-

term bond holdings are more volatile as compared to those whose underlying bonds are due to mature in a short period.

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In the case of FDs, you will have to pay tax on the interest accrued every year.



How fund managers mitigate interest-rate risk

There's not much a fund manager can do to avoid this risk as most debt-fund categories have been mandated by SEBI to operate within a defined range of maturity. However, there are

categories, such as dynamic bond funds, which have a flexible mandate in terms of duration. They try to profit from interest-rate movements by changing the maturity profile of their holdings.

How you can reduce interest-rate risk

Investors can deal with this risk by limiting themselves to fund categories that do not extend the duration of their portfolios beyond three-four years as funds in these categories will have a fairly limited impact due to interest-rate movements. For instance, short-duration funds invest in bonds whose maturity is not more than three years away. One may be tempted by the promise of dynamic bond funds that try to actively manage duration in response to changes in interest rates. However, in reality, outguessing interest-rate movements is very difficult, if not impossible. This is visible in the historical returns of these funds, which are neither chart-topping nor smooth.

Liquidity risk

It signifies the inability to sell a bond before its maturity as there are no buyers. This is the biggest villain in the Indian debt market and the reason why Franklin Templeton had to wind up six of its debt funds.

Investors were queuing up to redeem their investments but the AMC was finding it difficult to honour the redemptions as it could not sell large volumes of its underlying bonds.

This risk emanates from the inherent mismatch in the liquidity of debt mutual funds and their underlying portfolios. While debt funds provide liquidity to their investors, their underlying bonds, especially the lower-rated ones, may not be so liquid themselves. If a fund is unable to sell its bonds, it can still honour redemptions by borrowing. These borrowings reflect in funds' net payables.

How fund managers mitigate liquidity risk

When business is as usual, redemptions can be managed

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with inflows. Funds also use laddering of portfolio, i.e. their assets are spread across several bonds with different maturities. This also helps maintain some degree of regularity with which money keeps flowing back into the fund. Also, AMCs have lines of credit with banks, wherein they can borrow

against their holdings to tide over any shortfalls. However, in a liquidity-strapped environment, this too can dry up for lower-rated securities. While these measures help, if all investors were to show up together to demand their money, even the most efficient funds will likely land in trouble, akin to a bank run.

How you can reduce liquidity risk

Liquidity mismatch is inherent in debt funds so it can't be done away with completely. However, if you stick to funds with high-quality portfolios, this risk can be mitigated to a great extent. High-quality bonds tend to have takers even during stressed times and are likely to be the last ones to go under because of poor liquidity.

Signs that your debt fund may be heading for trouble

Outlier returns

If your debt fund is giving chart-topping returns, check how your fund manager is making that possible. If those returns come from taking high credit risk, that's a red flag.

High/rising allocation to lower-rated paper + Falling AUM + Rising net payables

This concoction can signal brewing liquidity issues. It is likely that redemption pressures are mounting, and the fund is finding it difficult to sell its holdings and has started to borrow.

Rising issuer concentration + falling AUM

A fall in assets coupled with a rising concentration signal the fund being stuck with a few bonds of some troubled issuers, which it is unable to sell. To meet redemptions, it might have to sell its healthier bonds, leaving the remaining unitholders increasingly exposed to the illiquid bonds. If these issuers are eventually downgraded, it can lead to massive value erosion for the remaining investors. This has happened with quite a few funds in the last three-four years. ☑

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