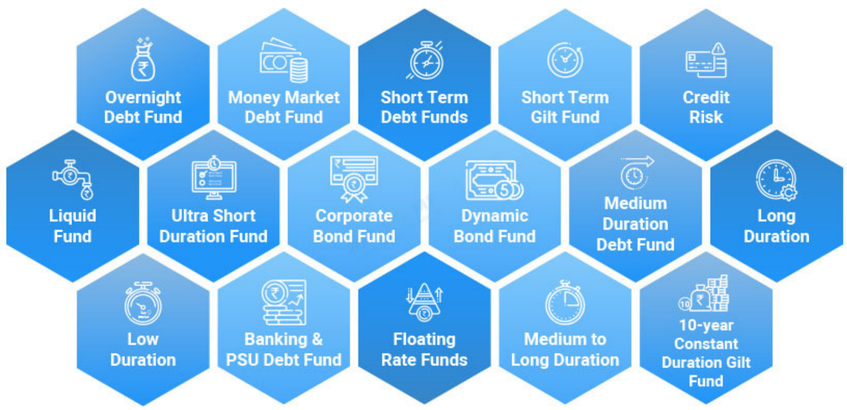
Understanding your Debt Fund Better

Debt Funds:

A debt Fund is a mutual fund scheme that invests in debt instruments that aim to generate fixed income. They are also known as income funds or bond funds. These securities are issued by private, and public companies and the government. **These instruments have a fixed maturity date and interest rate. Therefore, holding the investment for the required period or maturity profile is important.** Debt mutual funds are affected by interest rate cycles in the economy.

Debt funds collect money from various investors and this pooled money is then invested in various fixed-income securities as shown below:



Debt mutual funds are managed by professional fund managers. They invest the desired corpus in bonds issued by private, and public companies and the government as per the fund's investment objective.

Debt mutual funds are directly affected by interest rate movements. When interest rates are falling, existing long-term bonds will be in demand as New bond investments will have lower interest rates. Whereas when interest rates rise, the existing long-term bond values will be decreased as we will be getting new bonds at an attractive interest rate.

Parameters of selecting Debt Funds

There are some key parameters one needs to look into while selecting debt mutual funds:

1. Credit Rating:

This is the most important thing to analyze before investing in a debt fund. Investors should match their risk profile with the fund's credit rating. Liquid funds generally invest in treasury bills that are issued by the government and hence have a high credit rating. **On the other hand, credit-risk debt funds invest in low-rated bonds and are not suitable for conservative investors.**

Credit rating is like a report card for companies. An independent third-party entity like CRISIL or ICRA rates a company's bonds and provides a credit rating. This rating differs for short-term bonds and long-term bonds.

Short Term Bonds	
Rating	Interpretation
AAA	Highest Safety
AA	High Safety
A	Adequate Safety
BBB	Moderate Safety
BB	Moderate Risk
B	High Risk
C	Very High Risk
D	Expected to Default (Junk)

Long Term Bonds	
Rating	Interpretation
A1	Lowest Risk – Highest Safety
A2	Low Risk – Adequate Safety
A3	Moderate Risk – Moderate Safety
A4	High Risk
D	Expected to Default (Junk)

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A bond's rating greatly influences its interest rate. So, a low-rated bond will usually pay higher interest. This is a way for the borrowers to compensate you for the risk you take by investing in their low-rated bonds.

2. Maturity Papers:

The maturity of Papers is nothing but the period or tenure of the investment.. Some companies might require a loan of only three months. Whereas the government usually borrows for more than ten years. So, one should carefully look into the tenure of the loan to interest rates in the markets before buying Debt Mutual Funds.

Imagine we invest in a 10-year bond at 6% and the interest rate in the economy rises to 7%. Investors will end up losing on 1% returns for 10 years! To avoid this, evaluating the underlying maturity of the fund's papers is crucial.

3. Modified Duration:

It measures the sensitivity of the underlying bond prices to changes in interest rates. It's calculated in years. **The higher the duration, the more sensitive the underlying papers will be.**

Liquid funds have the shortest modified duration and hence are least sensitive to interest rates. Short-term debt funds have high modified duration than liquid funds. Whereas long-term debt funds have the highest modified duration.

For example:

The average modified duration of liquid funds is 0.09 years.

The average modified duration of short-term debt funds is 1.79 years.

The average modified duration of medium to long-term debt funds is 4.56 years.

Investors with a low-risk tolerance and a short-term investment horizon should stick with liquid funds or short-term debt funds. Investing in long-term debt funds is not recommended for conservative investors.

4. Average Duration:

As we saw earlier, the debt fund manager provides loans to various companies. The tenure of these loans can range between 1 day (overnight funds) to 10 years (gilt funds). This is all over the place. Hence average maturity is calculated. This shows the average maturity period of all papers invested in by the debt fund. It is also expressed in years.

For example:

The average maturity of Nippon India Short Term Debt Fund is 3.01 years.

The average maturity of Nippon India Gilt Fund is 5.44 years.

An investor with a goal in the next three years shouldn't invest in Nippon India Gilt Funds as its average papers will mature in 5.44 years.

5. Yield to Maturity (YTM):

This is the expected return from a debt fund. It measures how much return a fund will generate if the underlying papers are held till maturity.

For example:

The YTM of Aditya Birla Sun Life Dynamic Bond Fund is 7.83%. This means that investors can expect to earn 7.83% returns from the scheme. Comparing this with the category average will tell us if our fund is underperforming or beating its benchmark. **So, one should check if the respective debt funds have lower or higher YTMs than their category. If YTM is lower when compared to their category average it is better to stay invested in the benchmark index instead.**

It is important the investor matches their investment time horizon to the Yield to Maturity of an investment. Then only, will they realise the true potential of returns on the investment.

6. Current Interest Rate Scenario:

Studying the current interest rate scenario is important while investing in debt funds. Not all debt funds behave in the same manner to changing interest rates.

For example, Gilt funds usually perform better when interest rates are falling. But they generate poor returns when interest rates rise.

In 2018-2019, interest rates fell from 6.37% to 5.57%. During the same period, gilt fund returns increased from 7.75% to 13.26%.

Due to the pandemic, the Reserve Bank of India (RBI) cut rates to a minimum. Hence gilt funds have generated higher returns. But as soon as RBI starts raising interest rates, gilt funds will go back to generating a long-term average return of 7%-9%.

In 2022, the RBI raised interest rates six times and this had a negative impact on existing debt fund holders.
However, as mentioned in the Yield To Maturity Section above, if the investor stayed invested for the specified Duration of the investment, the desired Yield would have been achieved.

While investing in debt funds, investors must keep a track of interest rates.

7. Number of Securities:

Too much of anything is bad and this stands true for diversification. While diversification reduces overall risk, over-diversification can dilute the portfolio and your returns.

For example:

IDFC Floating Rate Fund invests in only 16 debt instruments against a category average of 46. This means the fund is extremely under diversified. The fund faces concentration risk. It has invested 9.44% in a debenture of Kotak Bank. Now imagine if, for some reason, Kotak Bank is unable to repay its debt on maturity. IDFC Floating Rate Fund will have to wipe off 9.44% of its portfolio. Hence avoid funds with over or under-diversified portfolios.

8. Asset Under Management (AUM):

For retail investors, it is always recommended to invest in debt funds with large AUM. This way, the fund does not face redemption pressure from investors. Also, funds with small AUM cannot negotiate good rates from issuers. They are forced to accept whatever interest rate the issuer is offering.

For example, The AUM of BNP Paribas Medium Term Fund is Rs. 32.77 crores. Whereas the AUM of ICICI Prudential Medium Term Bond Fund is Rs. 6,278.77 crores. Hence, it is in a position to negotiate for higher interest rates.

Risks in Debt Funds

Debt funds invest in fixed-income securities. But this does not mean that they are risk-free. Debt mutual funds do not face high fluctuations like equity funds. But they have their own set of risks which investors must be aware of before investing.

Let us understand some of the biggest risks faced by debt fund investors.

1. Credit Risk or Default Risk:

This is the most common risk faced by debt fund investors. Credit risk arises when the borrower (to whom our fund manager has lent money) is unable to repay the principal or interest.

For example, Franklin India Income Opportunities fund had invested 6.32% of its corpus in non-convertible debentures (NCDs) of Rivaaz Trade Ventures (RTVL). This is a subsidiary of the Future Group. On maturity, RTVL failed to repay the principal amount. This is credit risk.

When a company defaults on its payment, the fund can take any of the following two steps:

- Create a segregated portfolio: In a segregated portfolio, the fund manager will remove the 6.32% exposure to RTVL from the fund. It will create a separate portfolio for RTVL exposure. The fund will continue to hold this exposure till the time RTVL repays it.

- Re-value the exposure to Zero: In the second approach, the fund will write off the 6.32% exposure from the books. So, the value of this 6.32% exposure will become zero immediately.

Both these approaches are losses for investors. But in the case of the segregated portfolio, there is still hope that the company will repay the principal. This is not a total immediate loss for investors.

The best way to avoid credit risk is to invest in only AAA-rated funds and ensure that the exposure to corporate bonds is balanced by exposure to government bonds.

We at Dilzer only recommend AAA Rated bond investments to our clients.

2. Interest Rate Risk:

This risk is a part and parcel of investing in debt funds. Debt funds and interest rates have an inverse relationship. When interest rates increase, our short-term debt fund will generate lower returns. Interest rates are adjusted every quarter by the RBI. But it is almost impossible for investors to switch their funds every quarter. They can incur exit loads and short-term tax.

The best way to manage interest rate risk is to:

Creating an all-weather portfolio: You can further diversify your debt fund portfolio by investing in debt funds of varying maturities. For example: If your time horizon 5 years, you can invest as follows:

15% in liquid funds, 50% in corporate bond funds, 25% in medium-term bond funds, and 10% in long-term debt funds.

This is also called Bond Laddering.

Bond laddering is an investment strategy that involves buying bonds with different maturity dates so that the investor can respond relatively quickly to changes in interest rates. It reduces the reinvestment risk associated with rolling over maturing bonds into similar fixed income products all at once.

So, if the interest rate increases and the returns from long-term debt funds fall, the superior returns from short-term debt funds will even out your returns.

1. Market Risks:

The majority of investors believe that the net asset value (NAV) of debt funds does not fluctuate. This is not true.

For example Taurus Liquid Fund invested Rs 2,000 crores in commercial papers (CPs) of Ballarpur Industries. Credit rating agencies downgraded these CPs. What followed was a blood bath. The fund’s NAV fell by 7.77% in a single day. While this was a rare event, investors must also remember that debt funds are also linked to the stock market. So, they will experience fluctuations.

2. Concentration Risk:

This risk arises when the debt fund corpus is invested in a limited number of securities. So, a default by a single entity can wipe out 10%-15% of the corpus. Baroda Treasury Advantage Fund had invested 26.87% of its corpus in NCDs of Yes Bank. As Yes Bank was placed under moratorium in 2020, look what happened to Baroda Treasury Advantage Fund.

The fund's NAV fell from Rs 1,564.30 to Rs 1,222.91 in one day. That's a fall of 21.82% in a single day. Since the fund had a small AUM and a compact portfolio, it's over-concentration on Yes Bank NCDs wiped off a major portion of investors' wealth.

To avoid such situations, investors should ensure that the fund is adequately diversified as per category average. Any big deviations can be a red flag for debt fund investors.

3. Reinvestment Risk:

This risk arises when a fall in interest rate coincides with the maturity of debt fund papers. In this case, the fund manager is forced to reinvest the maturity proceeds in a lower interest-bearing instrument.

For example:

Aditya Birla Sun Life Dynamic Bond Fund has invested 4.55% of its corpus in debentures of India Grid Trust 2022 at 9.10% interest. Interest rates have been falling and are expected to fall further. So, the fund manager might not find another instrument providing 9.10% interest. Suppose the same debenture now offers 8% interest. In this case, debt fund investors face 1.10% (9.10%-8%) reinvestment risk. This is a systematic risk and cannot be avoided.

Apart from the above crucial parameters, one needs to consider an individual's Risk Profile, Investment Time Horizon, and Exit Load & Expense Ratio before investing in Debt Funds.

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