Mutual fund investing: Stick to debt

Drying-up liquidity and an increase in the cost of short-term funds for banks prompted a massive selloff in the bond market last week. Panic-struck investors went on a selling spree on July 16 as the government bond yield saw its sharpest one-day spike since January 2009 because the Reserve Bank of India (RBI) announced a slew of measures the previous night to suck up liquidity and curb volatility in the rupee.

The 7.16%, 2023 benchmark 10-year bond yield increased more than 50 basis points on a single day to close the session at 8.07% on July 16. And, in price terms, the bond lost a massive 3.5% in a single day. In fact, intermediate and long-term bond and gilt mutual funds had benefitted most from the sharp fall in bond yields till the end of May, which helped push up the performance of these categories of debt mutual fund.

On the expectation of a further rate cut by RBI, the funds saw huge inflows, especially from banks and companies. The total assets under management (AUM), according to the Morningstar Intermediate Bond category, grew from around Rs 49,000 crore at the end of May 2012 to Rs 90,656 crore at the end of May 2013 and grew above Rs 1,00,000 crore at the end of June 2013, despite the category reporting negative returns in June.

Analysts, however, say, at the current levels of yield from a medium-to-long-term perspective, investors can now get a very good entry point and invest across all debt funds based on their investment horizon. They also say investments in bonds must be carried out with asset allocation and time horizon in mind.

In a note, Dhruva Raj Chatterji, senior research analysts, Morningstar India, says the sell-off seems to be quite extreme, and too quick. “It would be advisable for existing investors, especially those who have got in the last couple of months, to not panic and sell off in a hurry, as they could be exiting at a loss. They should wait for the dust to settle and the rupee to stabilise a bit, before taking a decision,” he cautions.

Analysts say, over time, debt as an asset class works well and builds up a strong portfolio. Despite the current volatility in the debt, the allocation towards debt should not change much and the portfolio must be maintained as per the near-, medium- and long-term needs of the investors.

Any sudden positive measures or reversal of current measures can lead to a similar reversal in yields downwards; hence, gilt funds can also be looked at from a short-term tactical point of view for opportunistic returns.

“Investors who have a higher risk appetite and can digest volatility can consider this extreme move as a buying opportunity, and take duration call through the route of a dynamic bond fund or actively managed bond fund. However, investors who cannot digest volatility and have a lower risk appetite are better off with short-term and ultra-short bond funds at this juncture,” notes Chatterji.

To make a healthy bond portfolio, investors can look at ultra-short-term debt funds where the duration ranges from three months to a year and the investment is in T-bills, which are highly liquid and usually do not carry a lot of duration risk.

Investors can look at a balanced debt portfolio of short-term funds, which typically invest in T-bills and company debt for a duration of six months to a year. These funds do carry some amount of credit risk. One can also look at medium-term debt fund where the duration can vary from one to nine years. Since the fund manager takes active calls based on the current economic and market situation, these funds are less prone to interest rate volatility, but are more risky than short-term funds.

For long-term debt fund, however, there is a word of caution as it has the risk and highest sensitivity to any changes in the interest rate. And in a rising interest rate scenario, such funds always see negative returns for some period, something seen on July 16, as market expects interest rates to inch up going forward.

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