



# Go for accrual debt funds to avoid volatility

Thanks to a buy and hold approach, accrual strategy works well in most interest rate environments.

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**A**fter the 25-basis-point rate cut on 3 June, the RBI could pause for a while. This might leave investors who had bet on longer-duration funds a disappointed lot. Experts say that these funds will still do well, but the gains from them have got deferred. This development, however, once again underlines the risk in taking big bets on interest-rate movements and the need to build a diversified debt fund portfolio that also includes accrual funds.

## What are accrual funds?

Accrual-oriented funds focus on earning interest income from the coupon offered by bonds. In duration funds, in contrast, the focus is on generating a significant portion of returns from the capital appreciation that occurs when interest rates decline. Accrual funds too could earn some returns from capital gains, but these typically tend to be a small portion of their total return. Another characteristic of these funds is that they have a buy-and-hold mandate. "There is very little trading in these funds as instruments are held till maturity. On the other hand, duration funds are more actively managed, depending on the interest-rate view of the fund management team," says Renu Pothen, Research Head, *FundsSupermart.com*.

## Types of accrual funds

Within the open-ended category, there are two types of accrual funds: credit opportunity funds and corporate bond funds. Credit opportunity funds look for mismatches in the current rating of a bond vis-a-vis its fundamentals. A fund manager's research may reveal that the credit rating of a bond could get upgraded due to the improving fundamentals of the underlying company. When the upgrade happens, the bond also sees some capital appreciation. Since it also invests in lower-rated papers, a credit opportunity fund takes more risk than a corporate bond fund. The latter invests in higher-grade paper and does not take extra credit risk or look for mismatches between credit rating and underlying fundamentals.

## Their advantages

Accrual funds generally tend to be less volatile than duration funds. The accrual strategy also works well in most interest-rate environments—falling, stable, and sometimes

even rising. "The capital depreciation in a bond portfolio focused on the accrual strategy tends to be much lower in a rising interest rate environment as compared to duration funds, which tend to decline steeply in such circumstances," says Vishal Dhawan, Chief Financial Planner, *Plan Ahead Wealth Advisors*. It must, however, be added that accrual funds are not entirely immune to the effects of rising interest rates, especially when they rise a lot. But the impact is lower than on duration funds.

## Their flip side

Since accrual funds buy and hold much lower-maturity bonds, they do not reap the benefit of capital appreciation when interest rates fall significantly. Second, many investors who invest in fixed-income products do not want to take significant risks on the credit quality of the portfolio. If such investors unknowingly invest in a credit opportunity fund, which also invests in lower-rated paper, they could witness instances of delays in interest payment and even defaults.

## Who should buy them?

Accrual funds are suited for investors who wish to see very little volatility in their debt fund portfolio and desire stable returns.

These funds are also suited for those who

want to enjoy the tax arbitrage vis-à-vis fixed deposits. Instead of being taxed at 30%, investors in the highest tax bracket get taxed at 20% with indexation benefit on the capital gains in these funds. Even investors in the 20% tax bracket benefit since they get to avail of the indexation benefit.

## How much should you invest?

Within your fixed-income portfolio, first decide how much you will allocate to debt funds. Within this, allocate 70-75% to accrual funds and only 25-30% to duration funds. Moderate to aggressive investors should have this kind of allocation. More conservative investors may have an even higher allocation to accrual-oriented funds.

## Select carefully

Since the returns from accrual funds are not very high, it is important to stick to funds that have a low expense ratio. Next, look at the quality of paper within the portfolio. "Instead of investing blindly in the fund that has given the highest return in the past, make sure that you are comfortable with the credit quality of the bonds in the portfolio," says Dhawan. Finally, don't think of exiting accrual funds as soon as the period for which the exit load is applicable gets over. Invest in these funds with at least a 1-3-year horizon.

## ACCRUAL FUNDS YOU MAY CHOOSE FROM

When you factor in the better tax treatment, these funds outperform FDs by a decent margin.

### 1-YEAR RETURN

SBI Corporate Bond Fund	10.68%
Franklin India ST Income Plan	10.46%
Franklin India Income Opp Fund	10.26%
Birla SL Short Term Fund	9.54%
Reliance R Savings Fund-Debt	9.71%

### 3-YEAR

SBI Corporate Bond Fund-Reg	10.10%
Franklin India ST Income Plan	10.29%
Franklin India Income Opp Fund	10.08%
Birla SL Short Term Fund	9.71%
Reliance Reg Savings Fund-Debt	9.57%

### 5-YEAR

SBI Corporate Bond Fund-Reg	9.55%
Franklin India ST Income Plan	9.31%
Franklin Income Opp Fund	9.22%
Birla SL Short Term Fund	9.00%
Reliance Reg Savings-Debt	8.56%

Source: Ace MF. Data as on 11 June.