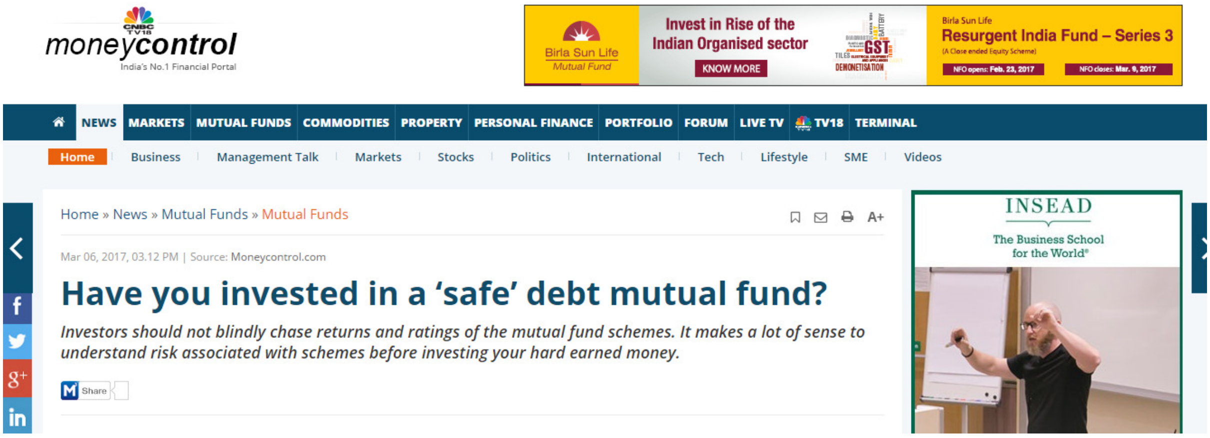

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Have you invested in a 'safe' debt mutual fund?

Investors should not blindly chase returns and ratings of the mutual fund schemes. It makes a lot of sense to understand risk associated with schemes before investing your hard earned money.

Investors in debt mutual funds in India have seen ugly surprises in last couple of months. While Taurus Mutual Fund's investors in debt funds saw negative returns due to a rating downgrade of a paper, investors in many other debt funds saw negative returns due to sharp spike in interest rates in last one month. In both situations, it was the investor who faced the brunt.

"Bond funds are exposed to credit risk and interest rate risks. Ignoring these two risks and merely running after returns will make one see such shocks," says Abhinav Angirish, founder of invest online.in, a Mumbai based mutual fund distributor.

For the uninitiated, the value of various fixed income schemes floated by Taurus Mutual funds fell by 7% to 12% in on 23 February as it held some papers issued by Ballarpur Industries, which were downgraded by credit rating agency.

Over last one month, some ultra short term bond (USTB) funds have reported negative returns as they were invested in long term papers which saw a fall in prices due to sudden spike in interest rates in the economy. USTB are seen as relatively safe bets by many investors. For the long term bond funds and long term gilt funds, investors saw worse falls.

Contrary to the last month, for the last calendar year debt fund investors have seen double digit returns. Consistently downward moving interest rates, on the back of the macro factors such as falling inflation or the demonetization led liquidity in the system, made most investors treat bond funds like quick money making machines.

10 year benchmark yield has moved to 6.516 on December 30, 2016 from 7.732 on January 1, 2016. After hitting a low of 6.183 on December 7, 2016, it has moved up to 6.842 on March 2, 2017. If one looks at one year return of the bond funds, the picture is really attractive for one searching for high returns. But a look at last one month returns may make you rethink. Here is a glimpse of the numbers.

Scheme category	1 year return	1 month returns	3 months return
Gilt Long Term	12.3%	-2.0%	-2.8%
Credit Opportunities Fund	9.9%	0.0%	0.8%
Debt short term	9.3%	-0.1%	0.6%
Debt long term	9.9%	-1.5%	-2.0%

The returns mentioned above are absolute returns as on March 1, 2017.

The sudden change in the fortunes of bond funds has its own reasons. Reserve Bank of India has changed its stance from dovish to neutral. This means that the interest rates may not go down from here much.

Also the US Fed is expected to hike interest rates in American economy, forcing interest rates to go up all over the world. No wonder, most experts are asking investors to shift their investments from long term gilt funds to short term bond funds or USTB funds.

Though the prescription appears simple the shocks cannot be ruled out even if you are in the right end of the yield curve. “Fund houses make money on the basis of the assets they manage.

To attract more money the fund managers have to ensure that the funds appear on the top of the charts which in turn forces them to take extra credit risk and extra interest rate risk,” explains a senior executive with a wealth management firm who prefers not to be named.

If you have seen a loss in last one month in your short term bond fund or USTB fund, do check your fund’s portfolio. There is a high possibility that the fund manager has invested in long term papers to maximize capital gains in case interest rate falls. When the interest rates fall, the prices of long term bonds go up earning capital gains for the investors. In reality the interest rates moved up and hence these schemes incurred losses.

“Some USTB funds have been running duration of one year and above against the expectation of around three months,” points out the wealth manager quoted above. For the beginners, duration is used to measure the sensitivity of the fund portfolio to the changes in interest rates. Duration of 3 years means, one percentage point increase in interest rates means a 3% loss for investor and the other way round.

The quench for the top of the table returns have made many fund managers and investors land on the wrong side of the markets. Picking the right candidates for your portfolio may be a bit difficult but is not a rocket science, says most investment experts.

“First define your risk appetite and your needs. While choosing a scheme look at the associated credit risks and interest rate risks in light of your risk taking capacity,” explains Dwijendra Srivastava, chief investment officer, Sundaram Mutual Fund. Look at the label of the fund and understand the investment style of the fund manager. If you cannot decipher it, approach an investment advisor, he adds.

Vishal Dhawan, founder of Mumbai based Plan Ahead Wealth Advisors advises investors to match their investment timeframe with the scheme’s modified duration. If you are investing for a week or two, do not think beyond liquid funds. While picking up any other fund, even USTB, do check the portfolio’s duration. If your investment timeframe is three months avoid picking up a scheme that has a duration of one year. Stick to a scheme that has a duration of three months or lower.

“Past returns should not be the sole guiding factor for picking a bond fund. The factors that contributed to past returns may not be present anymore,” says Vishal Dhawan. Long term gilt funds did extremely well in the falling interest rate regime. However they may be horrible investment choice if interest rates move up.

Investment portfolios of the mutual fund schemes have to be seen before committing your money. If you are investing in a gilt fund, you are not taking credit risk but you are exposed to interest rate risk of the portfolio duration is high. “Banking & PSU debt fund may appear to be a safe haven given the perception of very low credit risk. But if the fund manager has invested in long term bonds, then you are exposed to credit risk,” points out Abhinav Angirish. Do not generalize. Run through the portfolio, he advises.

Even if the fund is sticking to certificate of deposits, a conservative fund manager will go with papers issued by PSU banks whereas a bit aggressive fund manager will pick up a paper issued by a second rung private sector bank.

A careful look at the scheme’s portfolio will explain why it has earned a specific level of returns and what it can earn in future.

As the interest rates are about take a U turn, the interest rate risk may have a meaningful negative impact on bond funds. Ongoing structural reforms in the economy are expected to punish the undisciplined corporate, which may see more credit downgrades and defaults. These call for a serious relook at your investments in bond mutual funds. Are your investments in bond funds really safe as they appear?