

Invest in Long-term Bonds to Cash In on Lower Rates Ahead

Prashant.Mahesh
@timesgroup.com

Mumbai: The Reserve Bank of India may have dashed the market's hopes of a rate cut in December but investors can plan right away to make the most of the likely monetary easing over the next couple of years. Financial planners and distributors are advising investors to invest half of their fixed income portfolio to a mixture of long-duration funds, gilt funds and tax-free bonds, which are better poised to benefit from falling interest rates.

The market is expecting the key policy rate to be cut by 75-100 basis points gradually over the next 12-18 months. As interest rates fall, bond prices will move up, thereby giving investors a capital appreciation.

Rates and bond prices move in opposite directions.

The fall in consumer price inflation to 6.46% in September, the lowest since the new series of CPI was released in January 2012 and falling domestic fuel prices in the wake of weakening global crude oil prices make a case for cut in interest rates, said fund managers.

"With crude prices moving down, to around \$82 per barrel, and diesel prices cut, inflation will come down, which could help the RBI cut rates, early next year," says Lakshmi Iyer, head (fixed income), Kotak MF.

Long-term income and gilt funds may fetch superior returns as the yield on the 10-year benchmark falls. "The 10 year GoI benchmark which trades in the range of 8.15-8.2% could fall by 100 basis points over the next 15-18 months. This will give investors a higher capital appreciation in long-term income

funds and gilt funds," says Dwijendra Srivastava, head, fixed income, Sundaram Mutual Fund.

Fund managers said the government's fiscal deficit numbers would also play a key role in the direction of the 10-year bond. If fiscal deficit is lower-than-projected, it could strengthen the rally in the bond market.

Financial planners, however, caution that there is a risk if a scenario emerges where interest rates do not fall as expected. Unit-holders

could end up making a mark-to-market loss in the near term. "Investors with a high-risk appetite and a time frame of 18 months and above should shift a part of their portfolio from short-term funds to a mixture of income funds, tax-free bonds and

gilt funds," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Typically, when rates fall, bond funds, tax-free bonds and gilt funds, which have a longer maturity, benefit the most. "A tax-free bond with a maturity of 10-20 years could give you a capital appreciation of 4-5%, if interest rates fall by 50 basis points," says Vikram Dalal, MD, Synergee Capital. For example, the 9.01% NHB bonds, with a face value of ₹5,000 maturing in 2034, trades at ₹6,400. Now, if interest rates fall by 50 basis points, the capital appreciation will be to the tune of 5%. If the bond is held for a year, the tax-free interest income would be 9%, thereby taking an investor's total returns to 14%.

When rates fall, bond funds, tax-free bonds and gilt funds, which have a longer maturity, benefit the most

could end up making a mark-to-market loss in the near term. "Investors with a high-risk appetite and a time frame of 18 months and above should shift a part of their portfolio from short-term funds to a mixture of income funds, tax-free bonds and

Take a Long Shot

1 year return (%)*
(As on Nove 7, 2014)

Gilt Medium & Long Term	12.88
Income	11.33
Short Term	10.37
Gilt Short Term	9.07

* Average returns for the category



Source: Value Research