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Is the time for duration strategy in bond funds over?

Last year many income and dynamic bond fund portfolios had high duration and delivered double-digit returns. Duration-led returns are harder now due to slower pace of rate cuts and other factors

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Inflows in income funds went up by 44% in calendar year 2016 as compared to the previous year; and in 2017 inflows are already 8% higher than in 2016. Thanks to the downward rate cycle in domestic economy, income funds have seen more investors and inflows. In 2015 and 2016, many income and dynamic bond funds increased their duration to take advantage of the falling rates and fared well, delivering double-digit returns. Duration measures the change in price of a bond as interest rates change. Bond prices rise with fall in rates. However, the pace of rate cuts has since slowed and duration-led returns are now harder to come by. The last 1-year average return for dynamic bond funds category is at 5.85% and for income funds category it is 6.85%. Just like equity schemes, these funds too are more volatile in the short term and tend to give relatively stable range in returns when you consider a 3- to 5-year period.

Where did the return go?

The moderation in returns is led by fewer rate cuts last year and an expectation that the rate-cut cycle itself is near an end. Experts talk about one more cut at the most, which is priced in by the market already. The 10-year government security (g-sec) yield moved from 6.2% in November last year to 7% now, leading the bond market correction. External risk factors, concerns on fiscal deficit and inflation have also impacted bond markets negatively in recent months.

According to Prateek Pant, co-founder and head products and solutions, Sanctum Wealth Management Pvt. Ltd, “Globally, interest rates are moving up and we don't see domestic rates moving in the opposite direction for too long. Moreover, over the last year we are seeing the return of commodity super cycle and crude prices on an upward trajectory. This impacts the domestic import bill significantly. With the recent bank recapitalisation announcement, there are fresh worries about fiscal slippages. This, consequently, leads to worries on inflation and currency.”

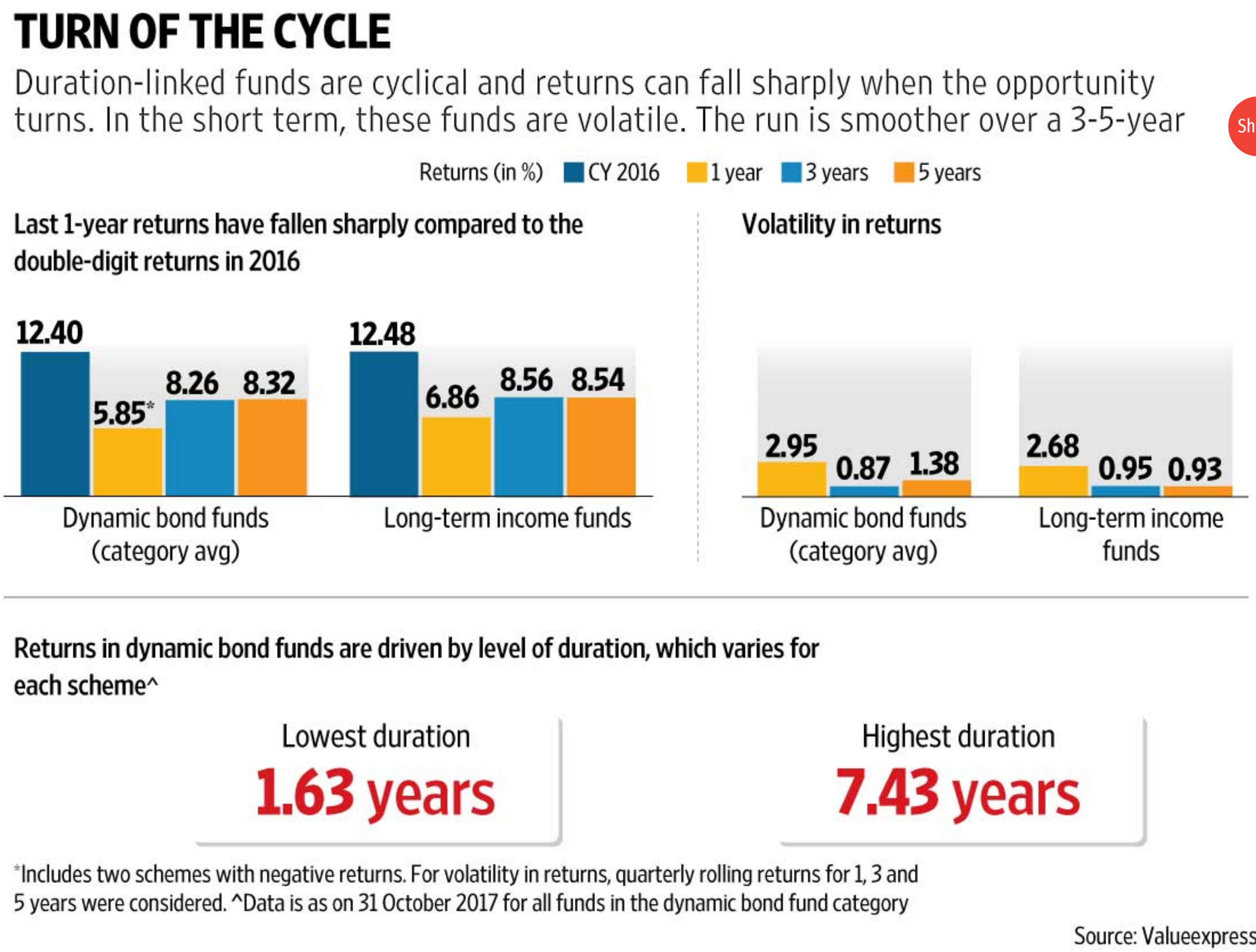
Many experts believe that for now the rate cycle has turned negative and risk-reward in high g-sec oriented funds is not favourable.

According to R. Sivakumar, head–fixed income, Axis Asset Management Co. Ltd, “A lot of the expected risk on the fiscal front may already be priced in. Yields may not fall sustainably from here. However, it is not looking very bearish either (risk of rising yields). Inflation may rise as a result of commodity prices moving up, but we don’t expect a significant shift. There is no clear directional shift to look forward to in yields, it’s going to be more about tactical shifts in the near term.”

Shifting away from duration

Looking deeper into individual fund performances shows there are outliers that have delivered 8-10% return even in the last year. Where did they manage the higher returns from? These are funds where first, the duration in the portfolio is lower than the category average; and second, there is a higher proportion of the portfolio that relies on accrual or interest income from corporate bonds and debentures.

Income funds are inherently volatile in nature owing to their exposure to duration through government securities. On the other hand, dynamic bond funds—if the fund manager chooses to—can move out of these securities meaningfully to curtail losses in a negative rate cycle. Currently, the range of duration in dynamic bond funds is quite wide (see graph). Funds that are still keeping long-dated g-secs and maintaining a high duration, are delivering a lower return. Those that have shifted strategy and focus on yield from bonds rather than opportunity in the rate cycles, are the ones performing better in the past year or so.



The way forward

The question remains, how should you approach your recent investments in these funds? Both these types of funds are opportunistic in nature and maximise returns in the brief periods when interest rates fall. If you can time the entry and exit into these schemes with the rate cycle, you will be able to benefit from the potential double-digit returns and exit before the trend changes.

However, for retail investors managing such precise timing is not a viable option.

In dynamic bond funds, fund managers keep readjusting their strategy based on the market, which results in smoother returns in 3-5 years. Average 3-5 year returns for the category, seen over the last 20 quarters, show a consistent range of 8-9% annualised return from both these categories.

According to Vishal Dhawan, founder and chief financial planner, Plan Ahead Wealth Advisors, “Dynamic bond funds give managers the flexibility to move across the spectrum of securities, depending on where the opportunity is. The call isn’t always accurate but the flexibility to shift means one needn’t stay where the opportunity has ended.”

Remaining invested for 3-5 years also means moderating your return expectation lower from the double-digit returns seen in previous years. Long-term income funds are riskier as they tend to maintain duration regardless of the market, owning to the fund investment objective. For short-term parking of money, both the categories are inappropriate thanks to the inherent volatility; and for those looking at medium- to long-term allocation, it should be at least 3 years for tax efficiency and smoother returns.

Risks should not be ignored

Asset markets move in cycles. The bond market in India saw a rally last year. Does this mean we are heading for a prolonged correction? It’s hard to predict that. However, there is some negative impact thanks to factors such as sharply higher crude oil prices, and fiscal risks arising from government’s bank recapitalisation plan. Pant says, “We turned negative on the duration cycle about 4 months ago. It is a relative strategy. We revisited whether g-secs presented a better opportunity or corporate bond-led portfolios, and found the latter to have a better risk-reward premium. This does not mean investing in credit funds where spreads have compressed. We prefer bond funds with higher-rated corporate bonds and limited g-sec exposure."

Think carefully before adding exposure to income and dynamic bond funds in the current market. Your choice may take longer than what you saw in the last year or two to reach the expected return. For investors who have a more long-term approach to investment, staying with their overall strategic asset allocation is more important.

Dhawan says, "Given the current trend in interest rates, we aren't advising a very high allocation to dynamic bond funds; within the fixed income allocation, a 20%-25% in these funds is suitable. A bullish phase may have warranted higher allocation. It is important for investors to remain diversified across assets and stick to the overall asset allocation with tactical changes."

For those looking to capatilize on opportunity presented by the rate cycle, it seems to have played out for now, with more risks in the near term than benefits.

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