Security: Fixed Income Investments

— By Shalini Dhawan | Sep 10, 2016 04:50 pm

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The stock markets have been keeping investors engaged these days as they scale newer heights. As I write this piece the Sensex has closed at around 29000 levels and the Nifty went past the 8900 level. On the other hand, investors who have been thus preoccupied with the stock market movements may be neglecting fixed income investments. Investors are possibly reading a lot about lowering of interest rates and may have felt that fixed income has become unattractive. This however may not be the case.

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On the fixed income side there have been many recent developments, such as the appointment of Dr. Urijit Patel as the new RBI governor of the central bank. The new RBI governor has a strong background of governance, policy research and deep experience of infrastructure financing. He has also been Deputy

Governor for more than three years. He belongs to the same school of thought like Dr. Rajan, on areas such as inflation, fiscal deficit control and liquidity management. It is expected that Dr. Patel very well understands the strategies that his predecessor Dr. Rajan implemented to get India to this stable monetary position and he is expected to maintain continuity on that front. Retail inflation at 4%+-2% is the target set by the monetary policy committee of RBI and this is what the new Governor shall endeavour to achieve. In addition, the creation of a Monetary Policy Committee (MPC) could provide an institutional framing to the setting of interest rates.

This year India has had a good monsoon and this should help contain pulses and vegetables prices. In fact, in many south Indian markets wholesale pulses prices have already reduced. Overall a favourable macro economic situation coupled with a good monsoon could help contain retail inflation. Although most of these above factors seem favourable for a reduction in inflation and interest rates, a lot would depend on the central bank's measures to deal with the sticky inflation situation of approx. 6% CPI we are facing today. For the near term therefore, we expect status quo. For the medium term we expect that rates may continue to head downwards, albeit rather slowly.

Assuming that happens, the overall interest rates on government bonds as well as corporate bonds would also fall thereby creating opportunities for debt mutual fund investors to gain, as their holdings would appreciate in capital and that would be a kicker to the current YTMs (yield to maturity) that is already available in the portfolio. In fact this can be explained by an example. The average returns that short term bond funds have given in the last one year are in the range of 9% range. The one year returns from dynamic bond funds are in the 10% range. In comparison, an AAA rated corporate FD would have returned investors in the range of 8% for a year. Whilst returns going forward are likely to be lower, they are still likely to be higher than inflation, making them a good investment option for portfolios where beating inflation is critical.

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Currently other fixed income investments such as FDs, PPF, small savings schemes are expected to have their rates of returns climb down from their current levels for reasons stated above. Investment options such as PPF and small savings rates are linked to the 10 year government security, which itself is currently in the sub 7% range. Therefore we can say that there is an opportunity available to investors to look at investing part of their funds to fixed income/debt mutual funds. Of course some varieties of debt funds such as credit opportunity funds do carry a higher level of risk as they invest in corporate bonds. Similarly gilt funds which invest in government securities tend to be volatile. Investors would need to study these varieties carefully before investing just as they would study their equity oriented investments.

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