MUTUAL FUNDS

How to choose the right debt fund

When you choose a debt fund, look not just at returns but also at the quality of its holdings, fund manager's track record, size of the fund and its expense ratio

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"THERE you go again. I thought it's Sunday and you would spend time with your family, not with business and financial publications," the sharp voice echoed across our home. I knew that my better half was right. But as I read articles on the first anniversary of the collapse of Lehman Brothers, I could not help but reflect: has only a year gone by? Everything seems so different today that it is hard to believe that only 12 months ago investors across the world were queuing up outside banks to withdraw their deposits, worried that they would collapse. The safest investments in the world then seemed to be cash under the pillow, gold, or US treasury bills. And today? In India, with equities, real estate and commodities having given spectacular returns and looking poised to do well in future as well due to global liquidity, no one wants to look at cash or bonds anymore.

"If you aren't joining me, tell me what is keeping you so engrossed," went the familiar voice again. "Well, I was thinking about changes in the financial markets over the last 12 months, and how debt mutual funds which were the favoured instruments just a few months ago are shunned today." The same investors who convinced themselves that the next 25 per cent per annum returns would be made in debt funds are today licking their wounds and trying to make a quick escape, that is if they have not done so already.

"Licking wounds seems like a phrase associated more with commodities, real estate, stocks and running a business rather than with debt mutual funds," she commented.

"Hmm, ask the investors who bought gilt funds in early January 2009 and they will tell you that their investments are down in excess of 10 per cent," I said.

Her jaws dropped on hearing about negative returns from gilt funds. Then she asked, "Should one buy debt mutual funds at all if they can give negative returns, especially in an environment where equities, real estate and commodities seem to be the places to invest in?"

"While it is always tempting to chase the highest returns, for most investors it is advisable to construct a balanced portfolio using a combination of assets: equity, real estate, commodities and debt. The appropriate mix should be dictated by factors like your financial goals, contingency corpus requirements, outstanding liabilities, and so on. And if one is going to hold debt in one's portfolio, the moot question is whether one should build the debt exposure through products other than bank deposits, and if yes, how does one go about choosing these instruments?"

To begin with, it is critical to understand the structure of the debt markets. Debt markets in India are largely composed of institutional players like banks, insurance companies and mutual funds. Participation by individual investors is low. Due to their largely institutional composition, most news, good or bad, tends to get discounted in advance. Therefore, even though it is possible for individuals to buy debt instruments directly, it may be prudent to invest via mutual funds.

Debt mutual funds invest in different debt instruments including government securities, corporate bonds, commercial paper and non-convertible debentures. They are also available across different maturities, with liquid funds having the lowest maturities and gilt funds running maturities of up to 20 years.

Debt mutual funds are more efficient from a taxation perspective than bank deposits, especially for high-income investors as returns from debt funds in the form of dividend and long-term capital gains are taxed at lower levels than the interest earned from bank deposits. Of course, this may change with the advent of the new direct tax code. But as things stand today, there is a clear tax arbitrage available to high-income investors.

Besides, long-term debt mutual funds could offer a higher rate of return than a deposit if held for a long time period. Hence a combination of debt mutual funds and bank deposits would be ideal for investors.

Criteria for choosing the right funds

Since a wide range of debt mutual funds are available, the key parameters for deciding on the funds you should buy are as follows:

Expected time frame of investment. Debt instruments are exposed to interest rate risk, i.e., they tend to go up in value when interest rates fall and lose value when interest rates go up. For example, if you had invested in a deposit one year ago, you could have got a 10 per cent annual rate of return. A similar deposit today would fetch only a 7 per cent per annum rate of return. If you were allowed to get the 10 per cent per annum deposit today, you would probably be willing to pay a premium for it. Therefore, as interest rates moved down late last year, bonds went up in value. And as interest rates have gone up over the last few months, bonds have lost value.

Since interest rate movements are driven by many factors such as liquidity, inflation expectations, monetary policy and so on, all of which can vary from time to time, it is important to invest in longer-duration debt funds only if you have a longer time frame of three to five years, else it would make sense to use shorter-duration products like liquid funds, liquid plus funds, or short-term debt funds. Further, use Systematic Investment Plans (SIPs) in longer-duration debt mutual funds so that you can take advantage of the volatility in debt markets. While investors commonly use SIPs in equity products, not too many use SIPs in debt funds.

Quality of portfolio. The quality of debt instruments that mutual funds invest in could vary from sovereign paper such as government securities where there is no default risk to lower-rated corporate papers that offer higher returns but carry a higher default risk. It was quite common in 2007 for mutual funds to have exposure to real estate debt wherein the returns were higher, but so was the risk. Investors should be comfortable with the ratings of the instruments in the funds that they invest in. These ratings are available in the fact sheets published by mutual funds each month.

Since the Indian debt market is not very liquid, there could be times when it becomes very difficult for a fund manager to move in and out of his holdings (based on a particular view that the fund manager may have on the direction of the debt markets), especially if he is holding poor-quality paper. This was evident last year post the Lehman collapse, when some funds were unable to sell debt securities that they held and had to borrow through a special line of credit to meet redemption pressures. Hence, investors must avoid debt funds that don't have a quality portfolio.

Size of fund. From time to time, debt mutual funds could see large redemptions, as happened last year after the Lehman Brothers crash. If the fund size is large, the fund manager can meet these redemptions out of his cash holdings. He also has more choice regarding which instruments to sell off to meet these redemptions. (He will sell those on which he will have to book the least losses). The manager of a small fund doesn't have as much leeway and has to perforce book losses. Hence, while in equity funds a large fund size can pose problems (the fund manager needs many more investment ideas to earn high returns), in debt funds large size can be an asset as it helps produce stable returns.

Expenses. Since debt products have lower returns, expenses become very critical as a higher expense ratio eats into the investor's returns.

Fund manager's track record. The past performance data for a debt fund (or even an equity fund) no longer remains relevant if the fund manager who fetched those returns has left the fund. Good fund managers are few and far between. A good investment strategy would be to track the performance of star fund managers and move your investments with them when they move from one fund house to another.

"The Singapore Formula One race is about to begin. Let the fastest man win," came the television commentator's high-pitched voice. Before I became immersed in the race, I said to my wife: "In the financial markets, the fastest does not always win; the winner is the one who is better prepared and more balanced." ♦

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POINTS TO REMEMBER

- Debt mutual funds are more tax efficient than bank desposits, especially for high-income investors
- Long-term debt funds are likely to beat the returns from deposits if you hold them through several interest-rate cycles
- Go with a fund whose portfolio quality you are comfortable with
- Large-sized funds tend to provide stable returns
- Follow-the-star-manager can be a good strategy