

Match holding period with the specific strategy you choose

VISHAL DHAWAN

THE RECENT downgrade of a bond held by two schemes of a major fund house has brought risks involved in debt mutual funds back into the limelight. The episode has shifted the focus on how fixed income mutual funds work and how they should be used in a portfolio.

It is believed that robust portfolio construction (how you allocate your money across different debt mutual funds categories) is the most crucial element to be put

in place before buying debt mutual funds or reviewing the funds that you have in your portfolio. A well balanced debt mutual fund portfolio needs to have different elements combined together to deliver superior risk adjusted returns. There are 3 things to remember while building a MF portfolio:

DO NOT FOCUS ON RETURNS ALONE: Fixed income instruments suffer from an anchoring effect, the need for a minimum fixed return on the investment. This anchoring effect is especially evident for fixed income investments in India as the country has wit-

nessed a high interest-rate high inflation environment for a considerable period of time. Thus there has been an anchoring of return expectations to 9-10 per cent annually from debt. Even as interest rates and inflation have started to come down in the last few quarters, the anchoring effect has meant that there continues the desire to derive a 9-10 per cent annual return from a fixed-income portfolio. This has resulted in higher risks being taken to generate the level of return. Ideally return expectations should be set at 1-2 per cent over inflation rates for the next few years to balance the risk return tradeoff.

COMBINE DIFFERENT STRATEGIES: Debt mutual funds serve different purposes — liquid and ultra short-term funds are for parking temporary surpluses, and tend to outperform savings/current accounts in banks where short-term surpluses are typically kept. Accrual oriented funds tend to buy shorter term bonds for a period of 1-3 years and could invest in a combination of higher- and lower-rated bonds. Duration oriented strategies tend to buy longer term bonds to try to take advantage of falling interest rates and create capital appreciation for investors. Dynamic bond funds have the flexibility to

decide how the fund manager wishes to allocate the money across the mentioned strategies. In addition, there are also fixed maturity plans (FMPs) which hold bonds to maturity to try to lock into a certain rate of interest. A clear understanding of each of these strategies is critical, and to combine them together to create a well diversified portfolio is imperative.

ALWAYS KEEP TIME HORIZON IN MIND: Each of the above strategies is suited for a certain holding period and it is therefore critical to match the period with the strategy. A

mismatch in holding period expectations and portfolio construction could cause a significant challenge.

Factors like modified duration and average maturities of the portfolio, exit load structures and composition of underlying securities must be monitored. Also remember that long-term capital gain benefits on taxation on mutual funds kick in after a period of three years.

The writer is a certified financial planner and founder of Plan Ahead Wealth Advisors, a Sebi-registered investment advisory firm.