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Keep these 5 factors in mind while investing in bond funds

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Bond funds make a lot of sense for investors who are looking for slow but steady growth. They are tax-efficient too compared to the good old fixed deposits for individuals in higher income tax bracket. But contrary to popular perception of being risk-free, they are fraught with risks. Here are five factors you should be aware of before committing your money.

Credit risk

The portfolio of bond funds comprise investments in instruments such as treasury bills, commercial papers, government securities, certificate of deposits and bonds. Each of these differ from each other in terms of credit risk. Simply put, credit risk is the chance of default by the issuer of the instrument. Credit risk impacts investments in two ways. First, a default may lead to permanent loss of capital. In case of rated instruments, papers with AAA rating are seen as the safest bet. Not a single AAA rated long term instrument rated CRISIL AAA has ever defaulted, says CRISIL default study 2017.

A change in rating issued by rating agency also impacts bond prices. A rating upgrade pushes up bond prices and a downgrade pulls down prices. As per CRISIL default study 2017, during 2007-2017 around 95.3Â percent of CRISIL AA ratings remained in that category at the end of one year; 1.2Â percent were upgraded to CRISIL AAA and 3.5Â percent were downgraded to CRISIL A category or lower. The numbers mentioned above are just for understanding purpose and are expected to change over a period of time.

â€œAlways check the portfolio of the schemes. If the fund manager is taking undue risks to boost the returns, avoid such funds,â€ says Vikas V Gupta, Chief Investment Strategist, Omniscience Capital. He cautioned, â€œLiquid funds are marketed as safe investment bets. However, many of them invest in commercial papers issued by corporates which carry credit risk. Ideally, liquid funds should have a sizeable chunk of their money in treasury bills and government securities maturing in three months.â€

If you are comfortable taking extra credit risk for extra returns, do consider credit risk funds. As the name suggest, these funds invest in bonds that carry high credit risk. These schemes are expected to reward you with extra returns for the extra risk you took.

Interest rate risk

Existing investors in bond funds have learnt it hard way over the past couple of years. For the uninitiated, when interest rates go up, bond prices fall and vice-versa. The 10 year benchmark yield has moved closer to 8Â percentÂ nowÂ as compared to 6.18Â percent recorded on December 7, 2016. The rate of interest changes is seen the most in long dated bonds. If you have been holding long dated papers, you have pocketed moderate returns. Government securities funds investing in long term government bonds lost 0.6Â percent over the last one year on an average.

If you are not too comfortable with interest rate risk, stick toÂ short duration bond funds, which earned 4.5Â percent over the past one year.

Expenses and exit loads

Double-digit returns potential in equity funds make many Indian mutual fund investors ignore the expense ratio of mutual fund schemes. In bond funds, you have to be very careful. â€œKeep a track of expenses. Any uptick in expense ratio pulls down returns payable to investors,â€ says Gupta.

There are many short duration funds and corporate bond funds that invest in high quality papers and charge very low expenses. On the other hand, there are credit risk funds that charge high expenses and invest in low rated high risk bonds to earn extra returns.

â€œInvestor returns - arrived at by deducting expense ratio from portfolio yield-to-maturity - must be compared by investors before taking investment decision,â€ says Vishal Dhawan, Founder and Chief Financial Planner of Plan Ahead Wealth Managers.

For example, a short duration fund investing in high quality papers may have portfolio YTM of 8.3Â percent and have expense ratio of 40 basis points. Here investors are expected to pocket 7.9Â percent returns, other things remaining the same. Now compare this with a credit risk fund that comes with YTM of 9.1Â percent and expense ratio of 1.6 percent, which nets an investor 7.5 percent. If investors are not getting adequately compensated for the extra risk they are taking, then there is no point taking that extra risk.

Do check the exit loads at the time of investing. If you have to sell before the stipulated time, the fund house deducts exit load, eating into your returns.

Fund manager risk

There are many celebrity fund managers in the equity space. However, not many are bothered about knowing more about the fund manager when they are investing in bond funds. â€œA fund manager's role is critical in dynamic bond funds and credit risk funds as the fund manager takes interest rate calls and credit risk decisions,â€ says Dhawan. Change of guard may change the performance of the scheme.

Changes in AUM of the scheme

Large changes in assets under management may change the expense ratio of the fund. A sudden dip in the assets may push up the expense ratio leading to lower returns.

One should also understand that a few strategies work the best with limited money. â€œSudden large investments in credit risk funds may force the fund manager to settle for sub-optimal investments in already illiquid corporate bond market,â€ says Dhawan, adding: â€œHowever, this is not a risk in government bond funds, given the ample liquidity.â€