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Which funds should you invest in after RBI rate hike?

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Invest in liquid funds if you have a horizon of three months, ultra-short-term for six months, and low-duration funds for one year, says Sanjay Kumar Singh.
Illustration: Uttam Ghosh/Rediff.com

The Reserve Bank of India's Monetary Policy Committee raised the repo rate by 25 basis points to 6.5 per cent.

After two consecutive rate hikes, it is expected that the MPC will pause in October.

However, most experts expect the current trend of rising interest rates to continue for at least the next 12 to 18 months.

Debt fund investors should bear this point in mind when building their portfolios.

Investors should steer clear of longer-duration funds and stick to shorter-duration funds.

Says Vidya Bala, head of research, FundsIndia.com: "This hike only makes liquid and all other accrual-oriented debt fund categories more attractive. We have seen a sharp increase in the yield to maturity (*YTM*) of fund portfolios in these categories over the past two months."

For instance, the average YTM of liquid funds has increased from 6.8 per cent in April to 7.4 per cent in June this year.

The rise in yields was sharper in funds across ultra-short, short and medium duration. Yields may improve further in the future.

"Investors should make the most of the attractive yields, with low volatility, in the liquid, ultra-short and short-term debt fund space," adds Bala.

Take into account your investment horizon while building your portfolio.

The basic rule is that your investment horizon should be at least equal to or more than the average maturity of the debt fund you are investing in.

Invest in liquid funds if you have a horizon of three months, ultra-short-term for six months, and low-duration funds for one year.

Money that can be spared for three years or slightly more should be invested in short-duration funds.

These funds will allow investors to earn interest at a steady rate, and also provide indexation benefit.

"As your investment horizon increases, accrual income of the fund acts as a counteracting force. Even if you have a mark-to-market loss initially, the accrual income will make up for it," says Dwijendra Srivastava, chief investment officer-fixed income, Sundaram Mutual Fund.

Investors with a high-risk appetite may opt for credit risk funds. According to Sebi's new norms, at least 65 per cent of the portfolio of a credit risk fund must be invested in AA and lower rated bonds.

Only investors comfortable with this kind of exposure should invest in these funds.

"For this category, go with a fund house that has good research processes in place, and make sure that the portfolio is diversified," says Srivastava.

According to Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors, "Low-risk investors should avoid these funds completely. High-risk investors may allocate 10-15 per cent of their debt fund portfolio to them."

Fixed maturity plans (FMPs), too, have become popular currently.

"FMPs allow investors to avoid volatility. By investing in FMPs of a particular rating and tenure, investors can more or less fix the return they will earn," says Srivastava.

However, when you invest in an FMP, you don't have complete clarity on the portfolio, since it is not ready at the time of investing.

"FMPs also suffer from the disadvantage that they may have to be sold in the secondary market at a significant discount in case the investor needs to exit anytime during the tenure of the instrument," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

While FMPs can be part of investors' portfolios, they should avoid taking too large an exposure to them just for the higher returns they promise since they could expose themselves to liquidity risk.

Instead, they should have higher exposure to short-term debt funds, where they can view the portfolio and also exit whenever they want to, though these funds will be a little volatile in the interim.

Sanjay Kumar Singh

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