moneycontrol

Take a cautious approach to market-linked debentures

Structured products are meant for sophisticated investors

You may like them or hate them, but structured products are still in the business and are expected to do better this year in terms of funds raised by issuers. CARE Ratings, in its recent report titled ‘Market Linked Debentures: Heading for a new high in FY20,’ predicts that fund raising using market-linked debentures would soar to Rs 17000 crore in FY-20. This numbers stood at Rs 12246 crore in the previous financial year.

MLDs (market-linked debentures) are bonds offering an uncertain payoff to investors. The payoff is ascertained towards the maturity of the bond, depending on the clearly defined underlying condition. For example, a bond may pay 8 per cent if the 10-year benchmark bond yield quotes at 7 per cent or lower. But it will pay 9 per cent if the benchmark bond yield stays above 7 per cent. Some MLDs do offer principle protection.

Issuance on the rise

Recent reports of the Bengaluru police booking several top officials of the Karvy Group for allegedly cheating investors by promising returns of up to 18 to 20 per cent in structured products, brought structured products to the limelight, for all the wrong reasons. Though Karvy has clearly denied the allegations, investors should exercise caution while investing in structured products or market-linked debentures (MLD).

According to CARE Ratings, the average tenure of MLDs has been 2.89 years in FY-19, as compared to 2.92 years in the earlier year. The average fund raising using MLDs is expected to go up to Rs 1300 crore per month in FY-20. The same stood at Rs 1000 crore in the previous year. In the first quarter of FY-20, the issuances of MLDs with government securities as the underlying increased to 37 per cent of the total value from 26 per cent as on March 31, 2019. Bellwether equity index Nifty remains the most used underlying to design MLD. Around 63 per cent of the issuances used Nifty as the underlying index. In FY-17, only five per cent of MLD issuances were linked to government securities. Over a period of time the share of government securities linked MLDs has gone up steadily.

“Structured products are meant for sophisticated investors and investors must understand the structured products before investing in them, as the payoff is linked to the underlying,” says Pankaj Mathpal, managing director and CEO of Mumbai-based Optima Money Managers. As of June 20, the total rated volume for principal protected MLDs increased to Rs 45000 crore from Rs 37000 crore as on March 31, 2019. During the first quarter of the current financial year, issuers with AA and lower rating raised money using MLDs, which was 11 per cent of the total

MLD issuances. Indian investors are seen increasingly opting for lower rated MLDs for higher returns, according to the CARE Ratings note.

Vishal Dhawan, founder and chief financial planner at Plan Ahead Wealth Advisor says, “In an MLD, investors are paid on the basis of the direction of the move and the timing of the move. It is difficult to get both these calls right.” Investors must also understand that MLD comes with a fixed maturity date. If your direction is right, but timing is wrong and you want to wait it out, then it is not possible in an MLD. In an open-ended product, you can wait till the situation turns in your favour.

Investors are also exposed to credit risk associated with the issuer of the MLD. If the issuer goes bankrupt, even if you get the movement in the underlying right, you will not be paid. Though MLDs are listed on the stock exchanges, they are rarely traded and you should be mentally prepared to hold on to them till maturity.