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"Don't avoid debt mutual funds completely; invest carefully"

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Over the last few months, there have been multiple instances of investors getting concerned about the debt mutual fund schemes in their portfolios. These concerns have emerged across categories of debt schemes. For example, some Fixed Maturity Plans (FMPs) that most investors assumed were quasi fixed deposits and more tax efficient delayed payments for a portion of their monies, or rolled over the FMP. Some of the open-ended schemes across debt fund categories were also impacted, as investors who were chasing the highest yields, were suddenly exposed to the credit risks in the portfolio of certain corporates unable to fulfil their promised interest or principal repayments, and thus mark downs in NAVs of the schemes as a result.

The ongoing challenges that some of the debt fund portfolios face have made some investors shy away completely from this category, which we believe is not warranted as the benefits of debt funds in terms of taxation that is indexed for inflation, especially for higher tax bracket investors, and the higher possibility of a superior return to a bank fixed deposit alternative, continue to make it a critical part of investor portfolios. However, in order to reduce the possibility of these mishaps, some of the learnings from this event need to be kept in mind by debt fund investors.

Don’t chase yield on fixed income

The chase for higher yields and focus on past performance come with challenges. This higher yield on fixed income invariably comes with a lower quality of bonds, and it is therefore critical to focus on the quality of the portfolio rather than chasing the higher yield fund. If you wish to allocate a portion of your debt fund portfolio to higher yield strategies, you can do so keeping in mind that the possibility of higher returns is normally accompanied by a higher risk as well.

Look at portfolio concentration

The relative lack of liquidity on debt market securities in India has meant that in times of bad news on a particular corporate, the liquidity on that security dries up completely. It may therefore be critical to look at the concentration risk of the underlying portfolio. Try to ensure that not more than 3 per cent the portfolio is exposed to a particular security. You may need to seek the help of a professional advisor as sometimes the name of the security of the same group may be under different names, thereby making it difficult to correctly understand the group exposure.

Expense ratio matters

In debt funds, as the potential returns tend to be low, lower expense ratios on the chosen schemes can help you better your rates of return. You will also find that invariably higher quality portfolios tend to come with lower expense ratios, as the yields on the portfolio cannot support a higher expense. A good way to look at this is to compare schemes based on their yield to maturity and reduce the expense ratio of the scheme, and see if the difference between the net yield justifies the increased credit risk.

Diversification matter

Avoid more than 20% of your debt portfolio in a single scheme, to control single scheme risk

Stay with open-ended options

If there are things that make you uncomfortable, an open-ended option gives you a choice to exit. That means, you can make changes midway if warranted.

Investors need to be prudent with their debt fund strategies, and avoid exiting all debt mutual funds altogether. This would tantamount to avoiding playing a sport just because there is risk of injury, or throwing the baby out with the bath water.

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