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Don't bank on category average returns while choosing debt mutual funds

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A mutual fund investor looking at various debt mutual fund categories would shake his head in disbelief. The data just doesn't make sense. For example, the long duration category is offering around 16 per cent returns in the last one year, but medium duration is offering 4.88 per cent in the same period. The short duration category is offering 5.03 per cent, ultra short duration category is offering 5.88 per cent and liquid category is offering around 6.88 per cent in the last one year. Did you get drift?

Sure, the category average returns could be skewed at times. But how could medium duration and short duration categories offer around 2 per cent points lower returns than liquid funds? Aren't these schemes supposed to deliver higher returns than ultra short duration and liquid schemes? Didn't experts tell us investing in schemes with longer duration will fetch us higher returns?

Vishal Dhawan, founder, PlanAhead Wealth Advisors, say category average is not a perfect metric of judging the schemes. "The category average has laggards, too. If you look at the toppers in these categories, you will see that as the duration grows the one-year returns also increase,"says Dhawan.

Look at this data: the one-year returns posted by the top five funds in the overnight fund category is 6.22-6.33 per cent. Similarly, toppers in the liquid fund category returned 7.62-7.80 per cent. The top five in the short duration category have given 9.69-10.12 per cent in one year. And the top five in the medium duration fund category have given 9.56-10.74 per cent in one year. Does it make sense now?

Dhawan says lesson from the category average data is a different one: “If you have selected good debt schemes which are among the top 10, you would get good returns. However, if you choose a bad scheme even in the liquid or overnight category, you wouldn’t make good returns," says Dhawan.

Lakshmi Iyer, CIO-Debt and head product, Kotak Mutual Fund, says there can be periods when liquid funds can outperform all the other debt categories. For example, if you are in a constant rising scenario and the markets are extremely choppy, the inflation is high, the scenario is ideal for liquid funds. "India is not in that kind of an investment scenario," she says.

"It is all a function of how the yield curve is positioned. As the duration grows, the capability of giving better returns also increases. Very short-term needs, liquidity surpluses and emergency funds should go into liquid, other than that park you money in line with your investment horizon," says Iyer.

Vishal Dhawan says retail investors would find it difficult to understand the macro-economic fundamentals and the interest rate movement. "For such investors there is a simple rule: match your investment horizon with the duration of your debt scheme. Don’t get overboard of a category based on its short-term performance," he says.

“See, if you have money to be parked for two or three years, you should put it in either a short duration or a medium duration fund. If you don’t want to bet on the longer duration, it is absolutely fine but liquid fund is not a great choice here. This is because looking at a one year return in any given conditions can’t tell you about the performance of a category. Over three years if you see, the risk-adjusted returns from short or medium duration funds would be better than liquid funds,” says Lakshmi Iyer.