Why should debt funds be a part of your portfolio?

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Over the past several months, there has been a flurry of bad news coming in on bonds, ranging from companies having their bonds downgraded to the continued pressure on certain corporates in servicing their loans, bond interest and principal repayments. With the sharp economic slowdown resulting in widespread questions on whether the adverse NPA cycle of banks is likely to get further extended due to lower profits and growth of corporates, this concern on bonds has had a rub off effect on debt mutual funds as well.

Debt mutual funds invest in bonds of various types, and are therefore susceptible to the fall in NAV when the capital values of bonds fall due to the bad news in a certain corporate whose bonds the mutual fund owns. This concern has got accentuated as the alternatives that a large number of investors look at instead of debt mutual funds, that is, bank deposits have also seen a fall in interest rates, and equity market sentiment has also turned negative. There are a few clear benefits of investing in debt mutual funds:

POSSIBLE CAPITAL APPRECIATION

Unlike bank deposits where the rate of interest is fixed, debt funds can see capital appreciation when interest rates fall, as the capital value of the bond increases. The long the tenor of the bond or the modified duration of the debt mutual fund scheme, the higher the gain. Thus investors could find that over a period of time as interest rates fall in countries, debt mutual funds can give investors the opportunity to take advantage of falling interest rates. Investors also need to remember that as interest rates go up debt mutual funds can see their value reduce as the capital value of the bond decreases. Thus, it's critical to select the right category of debt mutual funds and keep a track of them on a regular basis.

TAX ARBITRAGE FOR HIGHER INCOME INVESTORS

Interest income is added to the overall income and taxed at the marginal rate. In addition, there could be a tax deduction at source, resulting in a reduced compounding impact on fixed income investments year on year, thus reducing overall returns.

In the case of debt mutual funds, for investors holding for a long term period, that is, more than three years, there is a benefit of indexation that is applied, and the long term capital gains tax rate is 20%. Thus, the effective tax rate is significantly lower, which can be very helpful for higher income investors, who are already burdened with multiple taxes and surcharges. As the tax is be paid only at the time of sale and not on an annual basis, the compounding benefit of the investment is available to the investor.

IMPACT OF PORTFOLIO CUSHIONING

Investors tend to get carried away by the high growth rates of assets like equity and real estate, and forget the inherent risks of those assets in terms of possible price depreciation and liquidity at bad times. Debt mutual funds can step in to provide both stability and downside protection in those times, as you would have noticed in the last few months. To avoid major accidents, investors in debt mutual funds should avoid chasing the highest yielding funds, and look for debt mutual funds with high quality bonds and well diversified portfolio.

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