



Debt funds face risks of default, liquidity amid Covid-19 scare

- Existing investors need to review the holdings of their funds and take a call based on their risk appetite
- As redemptions increase, remaining investors will be left with a higher exposure to risky debt

As Covid-19 disrupts the Indian economy and the markets, several second-order effects of the global pandemic lie in wait on the horizon. One of the most prominent among these is the risk of defaults. Little data on this has come out into the public domain yet, but the number of government-mandated restrictions on businesses have steadily increased over the past month, affecting their profits and debt servicing ability.

Debt funds, in general, are characterized by credit risk in varying degrees. It is the highest in funds that buy low-grade corporate bonds and the lowest in funds that buy only government securities. Though credit risk funds carry the highest degree of credit risk, other types of debt fund categories also have this risk. In return for taking on credit risk, debt funds get bonds with high yields. They also derive returns if their holdings get upgraded by credit rating agencies or the market prices them higher due to an improvement in their credit profiles.

In order to do well, these funds need an improving credit risk environment or, at least, a stable credit environment. Both the scenarios look unlikely as, in the present scenario, timely repayment may be difficult for both consumers and small and medium enterprises.

"The real economy is suffering enormously and there will be defaults across the board unless the government announces a bold fiscal package. This will impact credit risk funds," said Prateek Pant, head of products and solutions, Sanctum Wealth Management.

Falling stock prices have already caused rating downgrades. On 20 March, ICRA downgraded Future Group's Future Corporate Resources Pvt. Ltd below

investment grade, citing a rise in promoter-pledged shares due to a fall in stock prices. Even the HDFC Bank stock, considered India's least risky private lender, dropped 35% from ₹1,217 as on 20 February to ₹779 as on 19 March, on concerns about its exposure to unsecured consumer lending.

The Covid-19-driven distress is likely to amplify pain on an already stressed financial system. In a note released to its investors on 18 March, Suyash Chowdhary, head, fixed income, IDFC Mutual Fund, wrote that with another year of subdued growth almost a certainty, general pressures on somewhat weaker balance sheets are likely to continue. "It is a false perception in our view that yields on lower rated funds are attractive. The spreads between AAA and AA papers aren't compensating investors for the significant financial market and macro risks," he wrote.

Apart from the threat of defaults, another challenge that credit-oriented debt funds in India face is that of redemptions. *Bloomberg* reported on 20 March that investors withdrew a record \$35.6 billion from investment grade bond funds in the US. Funds that buy junk bonds, which are smaller in size, also saw an outflow of \$2.9 billion in the five business days ending 18 March, said the report.

As money flows out of debt funds, managers sell liquid and higher-rated bonds to meet redemptions, leaving the remaining investors with an even higher percentage exposure to risky debt. In the latest write-down on account of Yes Bank bonds, debt funds across the spectrum, including treasury advantage funds, short-term funds and medium-term funds, faced losses. Hybrid funds also faced deep cuts on the debt portion of their exposure.

"There is a liquidity problem in the debt market and this aggravates the already low liquidity that high yield debt has. Credit risk funds, typically, maintain cash buffers to tide over this problem but, in the present scenario, if there is a run on these funds, the buffers may not be enough," said Pant. However, Vishal Dhawan, founder, Plan Ahead Investment Advisors, a financial planning firm, pointed out that debt funds use various strategies to conserve liquidity, such as taking credit lines from banks to meet redemptions, having stiff exit loads and capping how much a single investor can invest in a debt scheme.

On the positive side, there could be rescue measures from the Reserve Bank of India (RBI). The US Federal Reserve has cut its rate to near zero, launched a new

asset purchase programme without a maximum limit and has stepped up bond buying, including municipal bonds. The European Central Bank has also announced a stimulus worth 750 billion euros and declared that there are no limits to its monetary policy.

RBI has announced fresh rupee-dollar swaps and long-term repo operations (LTRO) worth ₹1 trillion to soothe the bond markets. LTROs involve providing money to banks for a term of one to three years in exchange for government bonds. "If economic distress spurs defaults, there needs to be sustained intervention by RBI. This is likely to be in the government bond market through open market operations and the market expects RBI to direct LTROs in the PSU bond market," said Arvind Chari, head of fixed income and alternatives, Quantum Advisors Pvt. Ltd.

"Direct purchases of corporate bonds by RBI is unlikely," he added. So funds investing in low-rated debt may not benefit from this. However, A.

Balasubramanian, CEO, Aditya Birla Sun Life Mutual Fund, rejected the notion that funds with higher yields-to-maturity necessarily have higher defaults. He asked investors to note the recoveries from some of the resolved securities under the legal resolution process.

What you should do

Some advisers have asked investors to be selective about the debt funds they invest in. "I don't think people should avoid the credit risk category as a whole. They have to be fund-specific. The past year has separated the men from the cowboys in the credit space," said Shyam Sekhar, founder and chief ideator, iThought Advisory. "We are advising clients to stay in overnight funds only and not venture into credit or even duration. There can be a rally in long duration and PSU debt funds if RBI steps up bond buying, but until there's more evidence, we are not taking a duration call," said Pant.

Experts also highlighted debt funds' asymmetric risk-return structure. "Debt is about safety. If I want more return, I will invest in equity or hybrid funds," said Nithin Sasikumar, co-founder, Investography, a financial planning firm.

He recommended that existing investors should take a close look at the top holdings in their debt funds and the weightage of these holdings in the portfolios.

“If these issuers lack solid parentage or any other reassurance of payment (like PSU status), they should move to bank FDs.”

Investors should review their portfolios to check which funds are exposed to low-rated papers, particularly if there are a few concentrated holdings. Thereafter, depending on their risk appetite, they can continue to hold or shift to bank FDs or overnight funds. However, they should be mindful of exit loads and taxes. Capital gains in debt funds are taxed at the slab rate if held for less than three years and at 20% with indexation if held for longer.