

Passive investing gathers pace in the debt mutual funds space

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Low-cost debt index funds or exchange-traded funds (ETFs) popularized by Bharat Bond ETFs, launched in December 2019, have gained popularity among mutual fund houses. Asset management companies (AMCs) such as IDFC, Edelweiss, Axis and SBI have lined up such offerings with a focus on 5 to 7-year maturity funds and yields of 6-6.5%.

The USP of such launches is that if held to maturity, these funds mimic fixed deposits (FDs). They pay a predictable (though not guaranteed) rate of return and do so with more tax efficiency than FDs. The return, roughly speaking, is the yield of the fund minus its expense ratio.

IDFC AMC is slated to launch two debt index funds investing in government bonds maturing in six and seven years respectively. Edelweiss AMC also plans to launch two debt index funds, albeit investing half their assets in PSU bonds and SDLs (state development loans) in 2026 and 2027, respectively, (maturing five and six years down the line). Axis AMC has filed for two debt ETFs—five years and 30 years maturity. SBI Mutual Fund has filed with Sebi for a PSU Bond plus SDL ETF with a five-year maturity.



For its part, IDFC AMC is eschewing SDLs and PSU debt, sticking to central government securities (G-sec) only.

"In the open-ended space, where funds will flow in and out, and where the fund has to replicate the index, the G-sec segment due to its better liquidity, lower impact cost on buying/selling and rebalancing (to index) and comparatively lower pressure due to high supply of papers vis-a-vis SDLs offers a better opportunity," said Sirshendu Basu, head - products, IDFC AMC.

The AMC is instead betting on the steepness of the yield curve in the six to seven-year tenor.

"Two variants of six- and seven-year tenor each of G-sec Target Date Funds will be launched on 12 March. The yields on the indexes as on 28 February are 6.20% and 6.30%, respectively," said Basu.

Axis Asset Management has filed for a 30-year gilt ETF, investing in bonds maturing in 2050 apart from a target maturity debt ETF with a five-year tenor.

"We have filed two target maturity debt ETFs with Sebi. One is five years and the other is 30 years. The five-year ETF will be a combination of corporate bonds (AAA only) and SDLs, which makes it a unique product. We believe there is also enough value in high-quality corporate bonds, apart from PSU and state government debt," said Ashwin Patni, head - products and alternatives, Axis AMC.

Mutual fund executives have highlighted the high level of liquidity in government bonds, which such index funds are tracking and their ability to pick the 'sweet spot' in the yield curve.

"The USP for the fund is the 100% sovereign instruments, the steepness in the yield curve—at that six to seven-year mark, which may compensate for the limited rise in yields and 'roll-down'/target date strategy," said Basu. Industry professionals have also dismissed concerns about the risk of rising interest rates.

"I'm not worried about rising interest rates in a target maturity fund structure. Investors in these funds should hold them till maturity, which makes the interim NAV (net asset value) movement due to interest changes

irrelevant. If yields rise, investors can actually lock in higher yields by investing more," said Gupta.

Basu added: "The index funds are part of a barbell strategy that the AMC has been suggesting—with investors accumulating schemes at the short (overnight) and long end (six-eight years)."

The roll-down structure is not without risk. Such funds might face problems finding bonds of an appropriate maturity if there are large inflows.

If interest rates rise, debt fund NAVs suffer a mark-to-market impact. This is immaterial for an investor who holds the fund to maturity, but she will still end up locking herself in at a low rate.

However, financial experts have taken a positive stance on the offerings with some caveats.

"Given the steepness of the curve at present, products built with longer maturity and quality papers offer a decent opportunity for investors with a longer investment horizon. While roll-down strategies are used by many products such as corporate bond funds, the maturity usually ranges between three to four years. Investors comfortable with longer maturities and can stay invested through intermittent volatility can consider investing in them," said Prableen Bajpai, founder, Finfix Research and Analytics Pvt. Ltd.

Vishal Dhawan, founder, Plan Ahead Wealth Advisors, added: "Allocate a part of your portfolio to such products. The risk of inflation and hence interest rates rising is there, but this can be contained by limiting exposure to such five to seven-year maturity funds to a portion of your portfolio. Equity is not the ideal answer for a five to seven-year horizon. PPF has an even longer life span and is a good debt product to consider."