How you can strategise fixed-income investing

The key at this time is to avoid longer tenure products.

By Dipak Mondal |18th April 2022 10:05 AM

Image used for representational purpose only

NEW DELHI: Inflation is on the upswing, and the Reserve Bank of India (RBI) has given a clear signal that it now prioritizes inflation (control) over growth. This clearly means the Central Bank might be thinking of increasing interest rates.

Recently, group chief economic adviser of State Bank of India Dr Soumya Kanti Ghosh predicted that the RBI might hike the rate at which it lends to banks by at least 50 basis points by the beginning of June 2022. Also, yields on risk-free 10-year government bonds, which till recently were trading below 7% mark, have now touched 7.25% levels.

Given the fast-evolving situation, how should investors, who invest in fixed-income options like FDs, small savings schemes and debt mutual funds, make their investment strategies?

The key at this time for such investors is to avoid longer tenure products. Depositors should not get locked into any longer tenure FDs, while debt fund investors can invest in short-duration bonds which do not take unnecessary interest rate risks.

Bank depositors, small savings schemes

Banks are offering 5-5.5% on fixed deposits with 1-10 years tenure. They are fetching a negative real rate of interest if we consider the inflation prediction for 2022-23 at above 6%.

Bank fixed deposit rates are fetching lower interest rates because the banking system was flooded with easy cash thanks to several central bank measures to supply easy liquidity to banks so that they support businesses hit by the pandemic.

The RBI has been removing the extra liquidity from the system and as a consequence bank deposits rates should increase going forward. Investors planning to park their money in FDs should, therefore, do so in short tenure FDs for now, and wait for better rates in three-six months time.

Small savings schemes rates are linked to government bond yields of similar tenure, and they are revised every quarter. So, any increase in government bond yields should get reflected in the revised rates albeit with lag. The savers should remember that the government has kept the rates of small savings schemes unchanged for over a year now despite yields falling to lower levels. Therefore, they should not expect the government to immediately pass on the benefit of higher yields.

Debt mutual funds

With bank FD rates giving negative real rates of interest, savvy investors do opt for debt mutual funds which offer better tax-adjusted returns than FDs. But given the uncertainty and volatility due to the RBI’s changed policy stance, it would be important for debt fund investors to not take long-term bets yet.

“Rising bond yields are negative for long-duration bond funds. At this juncture, investors will be better off avoiding long-term bond funds,” says Pankaj Pathak, Fund Manager-Fixed Income, Quantum AMC. Investors should, instead, invest in funds which follow accrual and held-to-maturity strategies.

According to Lakshmi Iyer, chief investment officer (Debt) & head of products, Kotak Mahindra Asset Management Company, given the rising interest rate scenario, debt investors could look at optimising portfolio yields. Strategies

like floating rate funds are well suited as the underlying securities tend to adjust coupons at a faster pace. Coupons are interest paid on bonds.

Floating rate funds are those debt funds which invest in floating rate bonds, whose yields change with the change in benchmark rates.

For example, if a bond is benchmarked to say Repo Rate, the rate at which RBI lends to banks, then any changes in repo rate would also change the yield of the bond.

Target maturity funds also help in lowering interest rate risk as bonds in the portfolio of such funds are held to maturity, and the interest earned from holding these bonds are ploughed back into the fund. This is called accrual strategy, where the income is earned from bond interest rather than capital gains from change in price of bond.

"Investors would do well to use a combination of held-to-maturity products like target maturity funds, tax-free bonds and shorter duration mutual funds such as ultra-short, low-duration or short-term debt funds," says Shalini Dhawan, a financial planner and co-founder of Plan Ahead Wealth Advisors.

Ultra short-term or short-term funds which invest in debt securities with a very short duration of 3-6 months can also be ideal for parking money in uncertain times like these. These funds typically invest in treasury bills, commercial papers (CPs) and certificates of deposits (CDs). Low duration debt securities are less sensitive to change in interest rates.

"At the shorter end of the curve, yields will move in tandem with the liquidity in the system. Hence for short term duration, money market funds would come in handy for investors," says Parijat Agrawal Head Fixed Income, Union Mutual Fund.

HOW ARE THINGS STAKED UP

Key Indicators	Apr-22	Apr-21
Inflation*	6.95	5.52
Repo rate	4	4
MCLR#	6.55-7.05	6.45-7
FD rates (over 1 year tenure)	5-5.6	4.9-5.5
T-bills (91 day)	3.87	3.35
T-bills (182 day)	4.27	3.59
10-year Govt bond	7.25	6.21

* March inflation announced in April; all figures in %

Marginal cost of fund-based lending rate is rate below which banks cannot lend

Source: RBI, MOSPI

****