Are dynamic bond funds a good bet?

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On an average, returns from DBFs may not be much higher than a restricted category like short duration funds

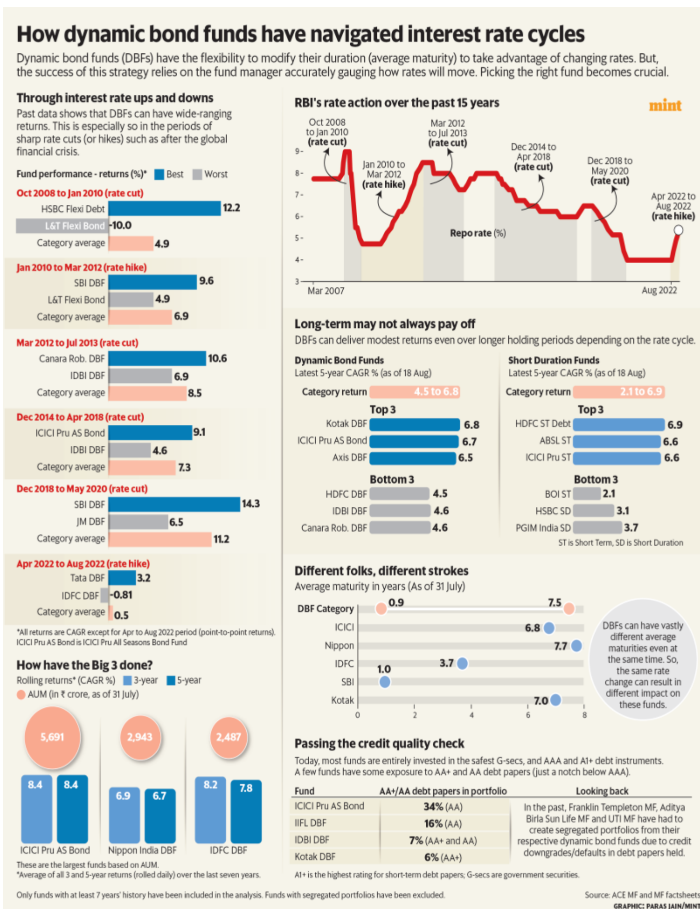
Dynamic bond funds (DBFs) seem to be the flavour of the season. They have the flexibility to modify the duration or average maturity of their overall debt portfolio to take advantage of changes in the interest rate cycles. Most of the other debt funds have a defined band within which they must manage their duration.

With bond yields moving up sharply, many believe that the market has largely factored in the future repo rate hikes. There is a limit to the potential adverse impact on debt funds i.e. fall in fund NAV as bond prices fall with a rise in yields—as and when the repo rate is hiked. Investing in debt funds that can take exposure to relatively longer maturity papers offering higher returns or, better still, in funds that can freely modify their mix of shorter and longer maturity debt papers as needed, is thus seen as a good choice today.

“In our view, if it is evident that rates have peaked, then gilts or constant maturity make for easier options," says Vidya Bala, co-founder, Primeinvestor.in.

Returns and Risks

Mahendra Jajoo, CIO – fixed income, Mirae Asset Investment Managers (India), says, “While their flexibility is a key-selling point, how well DBFs actually take advantage of it depends on the fund’s interest rate view and to what extent the fund positions its portfolio in time to benefit—minimize mark-to-market losses when rates rise and aim to provide better returns when rates fall—once the expected rate action materializes."



Fund	AA+/AA debt papers in portfolio	Looking back
ICICI Pru AS Bond	**34%** (AA)	In the past, Franklin Templeton MF, Aditya Birla Sun Life MF and UTI MF have had to create segregated portfolios from their respective dynamic bond funds due to credit downgrades/defaults in debt papers held.
IIFL DBF	**16%** (AA)	
IDBI DBF	**7%** (AA+ and AA)	
Kotak DBF	**6%** (AA+)	

A1+ is the highest rating for short-term debt papers; G-secs are government securities.

Only funds with at least 7 years' history have been included in the analysis. Funds with segregated portfolios have been excluded.

Source: ACE MF and MF factsheets

GRAPHIC: PARAS JAIN/MINT

For our analysis, we have looked at how DBFs have fared during the past phases of rate cuts and one prominent phase of rate hike, the latter when the repo rate went from 5% in March 2010 all the way to 8.5% by October 2011. All DBFs with at least seven years of history have been considered for this analysis (excluding funds with segregated portfolios).

We look at fund performance during the actual phase of rate hikes/cuts, assuming that fund managers would start modifying their portfolios in line with their changing rate view, even before the actual rate action is initiated. Data shows that DBFs can have wide-ranging returns, especially, in periods of sharp rate cuts (or hikes) such as after the global financial crisis. In other words, choosing the right DBF becomes very important.

On an average, the return of DBFs may not be significantly higher than a relatively restricted category like short duration funds (see table).

“Dynamic bond funds help do away with the need to change your strategy as interest rate cycle changes. However, it means that the fund manager should take the right active calls on

duration. However, within this category, the practices are so varied in terms of increasing or decreasing maturity that there is a high chance that you are in a fund that does not time it well," says Bala. She adds, “Currently, of the 25 funds in this category, about 14 have marginally if not significantly increased their maturity since March 2022, signalling that they are ready for a rate fall driven rally. But 11 funds have actually decreased their maturity or kept it steady".

Apart from the interest rate risk calls going wrong, it’s also worth looking at the credit quality of the fund portfolio. Today, a majority of DBFs hold only the ultra-safe government securities (g-secs), and AAA and A1+ rated (highest rating for long and short-term papers, respectively) debt instruments making them very safe on the credit risk front. A few funds, though have exposure to AA+ and AA rated papers, which are just a notch below the AAA-rated papers. In the past, Franklin Templeton MF, UTI MF and ABSL MF have had to create segregated portfolios in their respective dynamic bond funds due to credit downgrades / defaults.

Investor implications

Even though DBFs may have low credit risk, they are not for everyone since they carry interest rate risk. According to Jajoo, they are meant for those with a relatively high risk- high return profile. He further points out that with bond yields having already moved up sharply, today, target maturity funds that help investors increase the current portfolio yields with low range of variability can be a lower-risk option.

Vishal Dhawan, founder & CEO, Plan Ahead Wealth Advisors, lists out a few points that one must take note of before investing in a DBF. “One, you are exposing yourself to risk of the fund manager getting his interest calls wrong. Two, you need to be aware that if this view is getting implemented via using g-secs, it can be done more easily because that’s the most liquid part of the market. But the ability to move across other segments may be a little harder." He further says, “In addition to the possibility of the fund manager view going wrong, you could also be hit by the higher expense ratio". ACE MF data shows that most DBFs charge expense ratios of 0.3% to 1.0% (direct plans) and 0.7% to 1.7% (regular plans). Compared to this, most short duration debt funds charge 0.2% to 0.4% and 0.7% to 1.3%, respectively. Many target maturity ETFs and index funds (direct plans for the latter) charge 0.15% to 0.30% or even lower.

Dhawan feels that one can have exposure to such funds but this should be limited to not more than 20% of the total debt allocation. This is for investors who strongly believe in taking an interest rate view-based approach. For most other investors, he suggests 5-10% allocation at most.

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