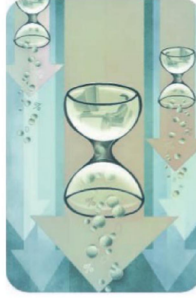

Changing investment pattern: Debt funds to rule the future

Aversion to debt funds will change as overall interest rates may fall with India's growth

HARSHENDU BINDAL

THE INDIAN mutual fund industry is almost Rs 13 trillion strong with fixed income or debt having a two-third share at about Rs 9 trillion, the rest being largely equity. The share of debt funds has not changed much from a decade ago when the industry size was less than Rs 2 lakh crore. Another characteristic which has not changed is the institutional dominance (mainly corporates and banks) of the category despite having grown by about 7 times since 2005. However, tax arbitrage and lower expenses for institutional plans now being history, the ratio is bound to shift towards retail investors over the next 5-10 years.

But we still have a long way to go as RBI data indicates that about Rs 90 trillion is parked in bank deposits, 10 times the money in debt mutual funds and over 35 times the retail debt AUM. This is mainly due to lack of awareness about the benefits offered by debt funds besides the 'assured returns' psyche of retail investors. This is bound to change as overall interest rates are likely to fall as India grows. In fact, many investors already shop for higher interest rates by moving from nationalised to cooperative banks.

Two factors that stand out in favour of debt mutual funds — variety and convenience. In terms of variety, debt funds are available across horizons and risk appetites. Accordingly they can be broadly classified into short term and long term debt funds. For short term investment horizons one may choose between liquid funds (3-6 months), ultra short term debt funds (less than one year) and short term debt funds (less than 3 years). One may choose income and gilt funds if investment horizon is more than 3 years.

On the basis of risk, one needs to look at interest rate risk and credit risk. The former is due to change in rates in the economy. This risk can be gauged by average tenure of portfolio holdings — longer the tenure, higher the interest rate risk. Accordingly, liquid funds carry the least interest rate risk while gilt funds carry the highest interest rate risk. In terms of credit risk (risk of default or delay in payment of interest and principal), gilt funds carry nil credit risk as they hold sovereign bonds.

So why not invest in only sovereign bonds. Higher yields do matter to investors whether it is FDs or debt funds. Government bonds fetch yields of 7.44-7.77 per cent over 1-10 year bonds. One therefore needs to invest in corporate bonds to beat these yields. But AAA bonds only offer about 0.45 per cent more for 10-year bonds while this is about 2 per cent if is an A+ rated bond. This clearly shows the inverse relation between credit rating and yields as highest rated companies borrow at lowest cost. Mutual funds thus invest in AAA, AA and A rated bonds, all of which are within investment grade rating of BBB(-).

Last but not the least is convenience. Most mutual funds are highly liquid. One can even start a monthly systematic investment plan or SIP for as low as Rs.500 per month.

The most pertinent question then is how to choose the right funds. The easier way out is to consult your professional financial advisor. Once you have zeroed on the debt fund category, narrow your choice by looking for a pedigreed fund house and fund management team besides looking at its vintage. If they have been around for 1 or 2 decades, it surely gives a lot of confidence having seen multiple market cycles.

The writer is President, Franklin Templeton Investments — India