Investment Avenues in Corporate Bond Segment for MF Investors

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Gone are the days when traditional investment avenue were the only investment avenue for fixed income investors, today the corporate debt segment provides immense opportunities to earn better returns across tenures.

The corporate debt segment: For the uninitiated, the corporate debt segment encompasses all the debt securities, which are issued by public and private corporations. These securities are issued by companies to raise money for a variety of purposes, such as to grow their business, to meet working capital requirements, to purchase new equipment or machinery, etc. When a corporate raises money they are known as corporate bonds, the government also issues bonds and securities when it needs to borrow money to fund its various projects, these are known as government bonds. When you buy either of these bonds you are actually lending money to the issuer of the bond and in return they promise to give you periodic interest and return your principal on a date which is the maturity date of the bond.

A lot of these bonds are classified differently based on who they are issued by and the nature of their borrowing such as corporate bonds, debentures, commercial papers, certificates of deposits, treasury bills, government securities, to name a few.

Can retail investors participate? Despite the vast opportunity it presents, the corporate debt segment is typically dominated by institutional investors like banks, insurance companies and mutual funds considering deals run into thousands of crores, leaving little scope for small investors to participate. Even if an investor were to invest on his own, choosing the right product can be a daunting task. Although most of the debt securities come with a credit rating based on various financial parameters and for a retail investor it may be difficult to decode these and match it to their risk profile.

Further, the tax treatment on these debt securities may not be conducive for investors in the highest tax bracket i.e. @30% considering the interest received is taxable in the hands of investors. Another problem that exists is the volatility in the secondary bond market. Since bond prices and interest rates are inversely correlated, prices fluctuate with any change in the interest rate movement, leaving an investor exposed to this risk. As a lay investor you may not be able to move in and out of these securities based on the sentiments as skillfully.

Mutual funds score high on various parameters: This is where Debt Mutual Funds come to your rescue. Not only do they provide you with the opportunity to invest across the corporate debt segment, they offer products that are designed to meet your investment objective and risk profile. Debt funds are usually classified based on their portfolio allocation -- short term or long term, risk levels, strategy - accrual or duration. They earn income by way of interest on bonds and by way of capital appreciation (on mark to market values of bonds) by actively managing the instruments in their portfolio based on the interest rate movement to deliver returns. Further, they score high on tax efficiency considering all their gains are converted into capital gains since mutual funds are pass-through instruments. After 3 years the gains (Long Term Capital Gains Tax) on debt mutual funds are taxed @ 20 % (with indexation benefits) or a flat rate of 10%. Be it in terms of liquidity, better returns or tax benefits, debt mutual funds score over other debt instruments.

How can you choose a debt fund? Typically, the choice of an instrument depends on your investment objective, time horizon and risk appetite. Regular income by way of periodic interest or dividend payment by bonds or mutual funds may be an underlying objective for many while long term growth by way of accruals may appeal to another section of investors. A close look at a debt fund's portfolio composition can give you an idea of the expected returns, risks and liquidity of each fund.

So, when picking a fund, you should watch out for a few things. Check the maturity profile of the fund's portfolio and whether this matches yours? The lower the average maturity period, the lower will be the fund's volatility and your returns. On the other hand, a fund with a long maturity period is likely to be more volatile, but the returns are likely to be better. Make sure the fund's portfolio is reasonably liquid i.e. easily traded on the debt market. Ideally, choose a fund with a large corpus so that there is limited impact of a large sale in the fund. Also, check the interest rate sensitivity of the fund based on the duration of its investments. Mutual funds give you access to all the information in their factsheets to make an informed decision. It is then up to you to take the right investment decision.

Types of debt funds

Liquid Funds are ideal for investors wanting instant access to their money, which is typically set aside for contingencies, making them one of the alternatives to piling money in a savings account. Your hard earning money could typically be lying idle in your bank account and not locked away for a long term considering you may need it in the near future. While this may work for some, those seeking additional return along with tax efficiency (in the highest tax bracket) can look at investing into liquid funds. These funds invest into instruments that are of extremely short term maturities (less than 91 days) i.e. money market instruments like Treasury Bills, Certificates of Deposits (CDs), Commercial Paper (CPs) and Bills of Exchange. Keeping up to their nomenclature, these funds are meant to provide investors with instant liquidity at any given point, hence you can withdraw your money anytime without any taxes. The short term nature of these investments largely does away with volatility and risk associated to the fund, allowing you to invest for as little as a day!

Ultra Short Term Funds, erstwhile known as liquid plus funds, like liquid funds provide an ideal investment option for very short term investment. They invest into short term debt securities like liquid funds with a limited exposure to longer term debt securities (maturity of less than 1 year). These funds are suited for investors looking for high liquidity with marginally higher risk to be able to earn commensurate returns. Investors who have short term surplus for a time period of approximately 1 to 9 months should consider these funds. These are also suitable in an upward interest rate movement scenario.

Short Term Funds are ideal if you don't need instant liquidity but may need this money over a period of the next 1 year to fulfill a short term goal like paying off a loan or an impending purchase. These funds deploy money into a basket of short-term instruments issued by the corporate sector and some amount into government securities, with a minimal exposure to money market instruments like commercial deposits or certificate of deposits unlike liquid funds s aims to earn higher credit spreads. The portfolio maturity of these funds ranges from one year to three years, in order to generate regular income at the same time monitoring interest rates.

Long term debt funds are suited for your long term goals like retirement or planning for your child's education. If you are willing to park your money for more than 3 years you could invest in long term debt funds as the portfolio maturity for these funds ranges from three years to ten years. Long term debt funds, as the name suggests, primarily invest a majority of their portfolio into long term corporate bonds and some amount into long term government securities, maintaining minimal exposure to money market instruments. By virtue of their investments, they are vulnerable to the changes in interest rates and are suitable for investors who have a higher risk taking ability than other debt categories. Needless to say, short-term funds tend to take low risk as you need your money in the near term, while longer-term funds take a bit of risk to generate returns over the long-term for you. When there is a fall in the market's interest rates, funds with the longest tenure can gain more and vice a versa.

Dynamic mutual funds offer active duration management! If you are looking at something more dynamic in nature without dealing with the stress of constant interest rate movement, dynamic funds are the ideal investments. These funds help investors minimize interest rate risk as they offer flexibility to alter the portfolio maturity according to the interest rate scenario. The fund manager actively manages the portfolio depending on his views on interest rates and juggles between longer maturity when interest rates fall and shorter maturity when interest rates rise. Some of the fund houses even have dynamically managed model-based funds.

Corporate Bond Funds for zero interest rate risk. If you wish to minimize interest rate risk and invest into corporate debt and securities only, then Corporate Bond Funds are the newer breed of funds you can opt for. These funds invest predominantly in medium to corporate bonds and debentures of varying maturities with the focus being on accrual income i.e. interest income. As the fund does not take any duration calls, it is least affected by interest rate movements unlike long term income funds. The ideal investment horizon of this fund is around 3 years considering the portfolio maturity of these funds would range from 3 years to 7 years. This is a good alternative to traditional investment avnues if you stick to funds that invest into high quality debt. But remember that this fund does bear credit risk depending on the credit quality of the bond that fund has invested into, a single default in interest or principal repayment by one company can hurt the fund and hence your investment at the time of withdrawal.

Fixed Maturity Plans (FMPs) are like your traditional investment avenue, which have a pre-determined maturity date and are close-ended debt mutual fund schemes i.e. they are not available for purchase and sale at all point in time. FMPs invest in debt instruments that bear a specific date of maturity, lesser than or equal to the maturity date of the scheme, while enjoying the status of debt funds. After the date of maturity, the investment is redeemed and the maturity proceeds are paid back to you as the investor. FMPs nowadays offer investment tenure of over 36 months in order to receive the benefit of long term indexation on the sale proceeds. Since the maturity date and the amount are known beforehand, the fund manager can invest with reasonable confidence, in securities that have a similar maturity as that of the scheme. Thus, if the tenure of the scheme is one year then the fund manager would invest in debt securities that mature just before a year. You may find that these units are listed on the stock exchange so that the investors may sell the units through stock exchange route in case of urgent liquidity needs.

If you want a fund that bears no risk of default, Gilt Funds are your ideal choice. Popularly known as G-Sec Funds, these funds invest only into government securities of medium and long term maturities issued by central and state governments. These funds do not have the risk of default since the issuer of the instruments is the government but then again they are highly susceptible to interest rate risks. These funds are classified as short term or long term gilt funds based on the maturity profile of the portfolio which ranges between three and twenty years. Owing to the higher maturity profile of the portfolio, these funds also see a higher fluctuation in the prices of the underlying securities owing to a change in interest rates. Only those who are comfortable with a high degree of risk and looking for capital appreciation can invest.