How to set your sails for a journey with debt funds

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Debt funds have faced flak in recent times after a spate of incidents that singed retail investors' pockets. But, this does not negate the importance of including debt funds as an asset class in one's portfolio. It only emphasizes the need to assess the risk-reward trade-off in various debt schemes and try to match it to personal goals.

A study by one of India's foremost rating agency CRISIL states that the closure of six debt fund schemes of a leading mutual fund house has frayed investor sentiment. But the study concludes that things aren't all bad. "Indeed, dive a little deeper and there are streaks of silver – options among various categories of debt mutual funds that can help ride over the challenges being posed by the pandemic's economic blow," it explains.

The moot questions for an investor are: Is it safe to invest in debt funds? How does a lay investor ensure he chooses a good scheme?

To begin with, the case for investing in debt funds is strong given that it balances a portfolio against riskier asset classes such as equities. This is because debt funds invest in fixed-interest generating securities such as corporate bonds, government securities, treasury bills, commercial paper and other money market instruments. The fixed interest rate for a pre-determined period of time makes debt fund investors earn a steady interest income and capital appreciation.

And, since the interest earned on these instruments is better than traditional investment options, it boosts overall returns of the investor.

That said, the plethora of schemes under the debt funds that an investor can choose from which best matches one's goals and risk appetite. Hence, it pays for an investor to be aware of the key parameters to look for, in debt fund schemes.

Risk-Return equation

Debt funds invest in securities of companies or government, the credit risk of which is monitored constantly by ratings agencies. Any change in macroeconomic trends or fundamentals of the issuers of securities held, leads to upgrade or downgrade of the security. This also changes the risk profile of the debt fund that holds these securities. Rating conveys the most likely scenario of creditworthiness based on the expected future performance of a rated firm.

While an investor may find it hard to access information on "rating action" by agencies, often news developments precede such actions. For instance, CRISIL's analysis since July 2018, just before the IL&FS issue in September that year, shows that as many as 26 companies held by mutual funds have defaulted till February 2020.

Typically, the riskier securities yield higher return. So, it is important to match the debt fund chosen to one's risk appetite. For instance, gilt funds invest in only government securities – high-rated securities with very low credit risk since the government seldom defaults. However, a credit opportunities fund often takes higher risks by investing in relatively weaker rated instruments, to earn higher returns.

Apart from credit risk, debt funds' returns are impacted by changes in interest rate. Typically, when interest rates fall, the yields or returns earned on debt funds are higher. As a result, the Net Asset Value (NAV) of a debt fund tends to fall with a rise in the overall interest rates in the economy.

Investment horizon

Various debt schemes invest in securities of varying returns and also varying time horizons. Normally, short term debt funds are more liquid and are ideal for those who wish to invest only for a short duration. Liquid funds invest in debt instruments with a maturity of not more than 91 days. As a result, the risk associated with them is the least.

Short-term and the ultra short-term funds too, as the names suggest, are typically ideal for investors who wish to park funds for about a year. Typically, longer the tenure better is the return profile in debt funds.

CRISIL's analysis of mutual fund portfolios showed that exposure to government securities and treasury bills (G-Sec and T-bills), the most liquid instruments in debt market, rose to 15.3% in April from 13.8% in March.

Diversification: Sectoral & Security Level

Investors should be mindful of sectoral diversification within a portfolio. Often rating agencies research sectors that may be facing headwinds temporarily as the financials of companies and their securities will be the most affected. For instance, power generation, real estate, construction, hotels, housing finance companies and automobiles can be considered as sensitive sectors given the Covid-19 pandemic and its impact on the economy and gross domestic product growth.

Going by the category of fund schemes, CRISIL research shows that banking and public sector undertaking (0.8%), corporate bond (1.4%) funds have the lowest allocation to sensitive sectors, while credit risk (25%) and medium duration (21%) funds have the highest exposure to sensitive sectors.

The other aspect to watch out is high exposure to a single issuer or even a sector. Concentration risk on security level or even sectoral level has the potential to jeopardise returns during challenging times. Market regulator SEBI (Securities and Exchanges Board of India) has capped the exposure to a single issuer of securities at 10%. Here, investors should always be mindful of is that a well-diversified portfolio with stable credit spreads is primed to weather any storm which may tend to arise from time to time.

There is a debt fund category to serve every possible financial need whether short, medium or long term in nature. When selecting a fund the ideal approach would be consult a financial advisor, as they understand these products well and also our financial goals to be achieved. As a result, a financial advisor is best placed to map our needs with a particular category of debt product.

To conclude, debt funds are effective investment vehicles to minimise risk in asset allocation, stabilise overall returns and provide liquidity.