Principles of Fixed Income Allocation for Retail Investors

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India's domestic savings, especially households have played a critical role in augmenting capital and contributing to high economic growth during the last 15 years. Retail investors have generally been net savers over the past years & contribute around 60% of gross savings to the economy (Source: RBI).

Within their financial assets, households held 53% of their assets in bank deposits followed by insurance (23.2%), currency (13.4%) & mutual funds forming 7% of their savings as on FY20 (Source: RBI). This reveals preference for fixed income assets especially towards more predictable streams such as fixed deposits (FD). However, with interest rates on deposits & small savings going down, investors are looking at alternate to traditional fixed income instruments in recent years.

A key development area for deepening of bond market is active retail participation similar to equities. This would not only help widen the market for bond issuers & help them diversify from banks but also give more choice to investors according to their risk appetite & investment horizon. For example, an investor who foresees a falling interest rate regime might want to lock-in his/her rates in a 30-year sovereign bond, something which can't be done in a FD.

While in theory, transition to alternate assets seems seamless, the actual experience of investors has been a mixed bag. The investors are used to deposit products & have often mistaken that the coupon rate of their bond or the YTM of their mutual fund portfolio would be close to their realized returns. Few investors inadvertently follow the FD allocation behavior following the highest YTM product often ignoring the associated credit/illiquidity risk leading to future distress. Credit averse investors who invest in relatively safer & liquid portfolio of securities like Govt bonds or AAA corporate bonds are uncomfortable with intermittent volatility which comes from mark to market of these securities.

Fixed income allocation done appropriately can play a critical role in a portfolio. By being defensive in nature, it can provide stability, income and diversification to other asset classes such as equities and real estate. However, before deciding on appropriate allocation, some basic principles need to be considered:

1) Interest rates are unpredictable: Below table presents the Implied US 10 year treasury yield estimates derived from the swap curve (reflecting consensus market expectations) on particular dates (Source: Bloomberg). As can be seen, interest rates were not always accurately predicted even by experts. The interest rate forecasts are generally based on reference points from prevailing market levels & assume certain economic conditions will be met. Hence, an actively managed bond fund is not supposed to get all the calls right but should be able to rebalance the portfolio according to the situation. Therefore, it does not mean that long duration funds are to be avoided, but one should avoid tactical allocation & invest for a longer-term horizon (more than 3 years) to ride out the recurrent volatility.

Date of Forecast	1-Jan-20	1-Jan-19	1-Jan-18	1-Jan-17	1-Jan-16
Horizon Date	30-Jun-20	31-Dec-19	31-Dec-18	29-Dec-17	30-Dec-16
Implied 10 year yield	1.91	2.71	2.45	2.46	2.35
Actual	0.66	1.92	2.68	2.41	2.45

Source: Bloomberg

2) Risk/Reward trade off: Just like any other asset class, there is a strong correlation between risk and return in the bond markets. In order to capture higher expected returns with the portfolio, one typically has to assume a higher degree of term risk or credit risk. As discussed above, market expectations keep on evolving. While the duration risk in a high quality, liquid bond portfolio can be hedged or rebalanced, it is often difficult to hedge or exit a credit risk position even if the fund manager changes their view. Hence, an investor in credit risk should assess the risk per unit (in bps) that he/she is willing to take for that binary situation of bond default or period of credit illiquidity. Even a well-diversified credit portfolio is subject to illiquidity in times of economic distress & more than modelled for credit defaults due to its inherent exposure to cyclical nature of assets. It is a myth that India is an emerging economy & hence as markets develop & more credit papers trade, credit funds might

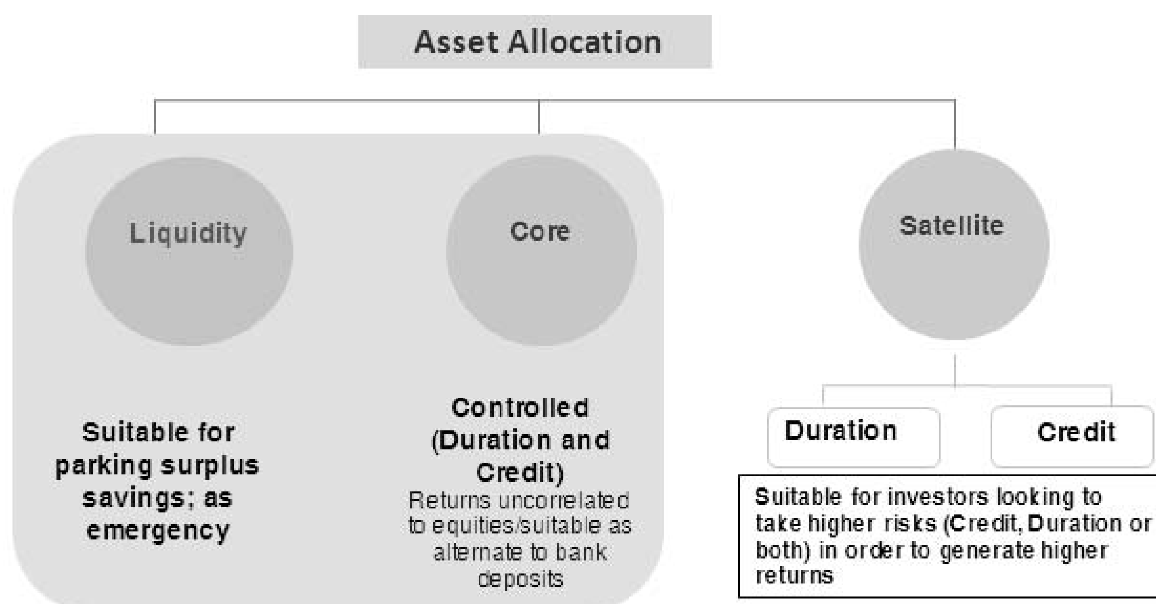
not need to side-pocket or delay their redemptions. During the volatile period of March 2020 as concerns on Covid-19 emerged, at least 76 European mutual funds totaling •100Bn suspended redemptions due to lack of liquidity in their portfolio.

(Source: https://www.fitchratings.com/research/fund-asset-managers/european-mutual-fund-gatings-rise-as-coronavirus-spooks-markets-20-04-2020)

Therefore, investors investing in credit strategies should bear in mind that credit markets by nature are illiquid & tend to freeze up in the times of economic distress, the very time an investor might need the funds.

3) Degree of cyclicality: Bonds, just as equity tend to perform depending on the economic cycle. However, credit focused & duration based strategies need to be considered uncorrelated with respect to their outcomes. A common misconception among investors in the past has been to look at widening of AAA/AA bond spreads & investing in lower rated portfolios in hopes of mean reversion. A sovereign/AAA portfolio does well in a period of low growth/low inflation whereas credit-oriented strategies which are typically exposed to more cyclical sectors such as real estate, commodities, lower rated NBFCs do well in a period of high growth. Hence a widening AAA/AA spread is only an indicator of increasing risk aversion & not a buy signal. The investor needs to assess the amount of cyclical component in their overall portfolio while making incremental allocations. For example, an investor heavily invested in equities needs to add a countercyclical component & will be better off in a low credit risk bond fund whose primary function is to reduce the volatility of their returns. An investor who is concerned about spike in inflation can look at money market/roll down strategies. An investor who has only marginally allocated to equities can add some credit risk subject to their risk appetite.

The objective in fixed income investing is not to eliminate but manage risk. An investor's allocation strategy is an interplay between his/her goals, time horizon & risk tolerance. An investor can look at their allocation via the following framework which combines their goals/needs/risk tolerance/horizon & yet is designed clearly & with a precise purpose.



A key feature of this simple allocation process is that each block is visibly defined in terms of risk i.e. duration & credit. For example, a 6 month (commercial paper) of an AAA PSU entity carries a higher duration rate risk than a 2 months CP of an "AA" real estate entity but the real estate CP carries a significant credit risk. This approach by bucketing all credit risk under one can provide greater control to an investor to tailor his/her portfolio depending upon their goals than a "multi- purpose strategy".

Liquidity: The liquidity bucket can be used by to park money which might be required at a short notice akin to an investor's savings account. The investment should be in reasonably risk-free strategies in high quality short term papers (usually up to 90 days) helping provide steady returns even in times of volatility. Examples of this strategy can be overnight/liquid funds, treasury bills, bank deposits etc.

Core: As seen earlier, majority of the fixed income investors in India have traditionally been investing in bank deposits & are more comfortable with them but forced to look elsewhere to enhance their returns. However, they still seek predictability & safety of the fixed deposit. Hence, bulk of their allocation needs to control for both duration & credit risk to provide steady returns over a rate cycle. This can be achieved by investing in short term papers (3 months to 60 months) depending on the shape of the curve/liquidity/view on interest rates. Investors should keep in mind that one should enter into these strategies with a recommended minimum investment horizon in mind to generate optimal returns. Examples of this strategy could be high quality ultra-short/low duration/short term/roll down strategies in a mutual fund/ETF format or direct investments in Govt/corporate bonds. As the focus of this strategy is to offer predictable returns with down side mitigation, investors need to be careful not to blend credit strategies in the core bucket which carry asymmetric capital protection/liquidity risk.

Satellite bucket: This segment is suitable for class of investors who have deeper understanding of debt markets, are looking for longer term allocation to fixed income (3 years+), want higher returns & can tolerate commensurate volatility. Investors wanting to play interest rate cycles & make higher returns through duration can opt to invest in longer term liquid bonds directly or through long duration mutual funds. Investors who expect upturn in growth, improvement in corporate balance sheets, credit upgrades & hence credit spread compression can look at credit funds or lower rated bonds directly. However, both these strategies require frequent evaluation & hence better suited in a mutual fund format.

Conclusion

"Simplicity is the ultimate sophistication" *Leonardo da Vinci*

Financial stakeholders like regulators, exchanges, issuers, asset managers have been grappling with the idea of deepening bond markets for a long time. It is a chicken & egg story where some participants feel that a robust & a deep bond market will help attract retail investors whereas some participants feel that active retail participation should be encouraged especially in lower rated bonds which will lead to creation of a deeper market. However, most of the retail investors do not innately understand fixed income. Hence it is important for them to first understand & clearly demarcate the risk/reward of their allocations to ensure positive experience, continued investments in mutual funds/bonds & in the process widen our debt markets. The above allocation framework simplifies the choices for the investor & also gives greater control as he/she can measure the precisely contribution of each segment for future investments.

MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY.