Corporate bonds for the retail: Opportunities & challenges

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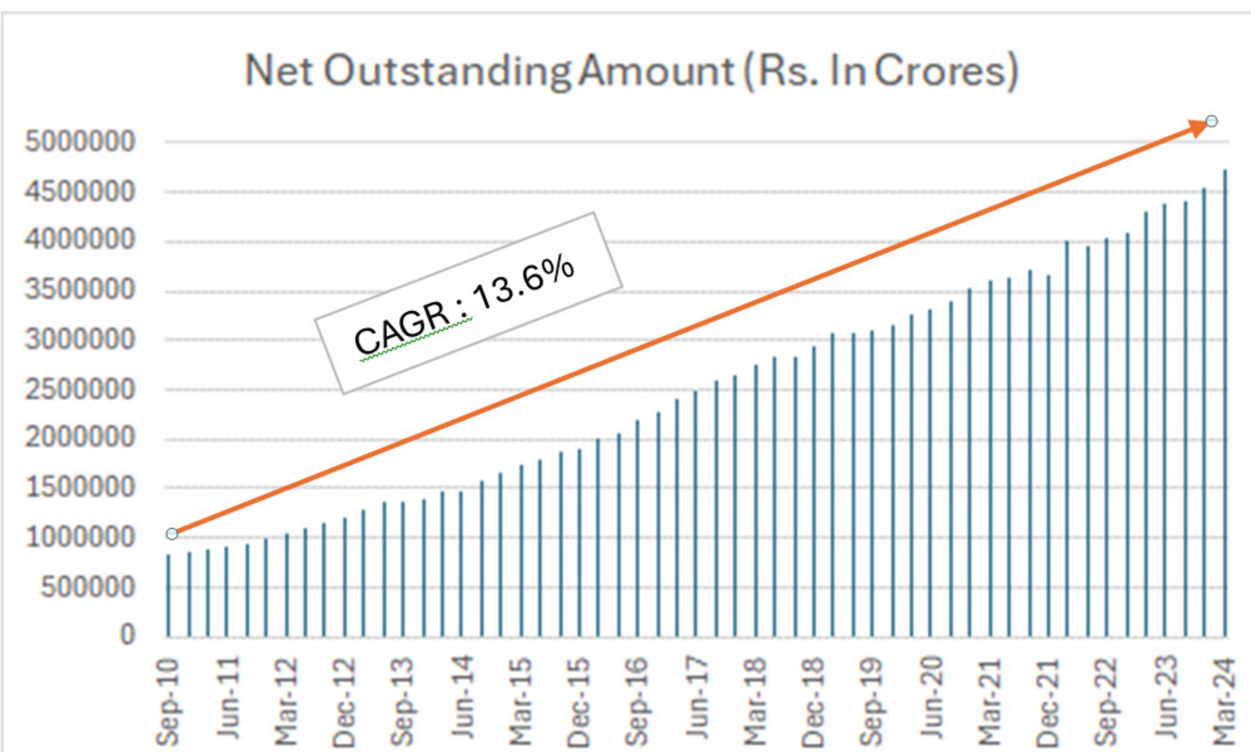
In the last few decades, retail investors worldwide have been looking at financial markets in greater numbers to build wealth efficiently. Indian investors have also been a part of this trend and have invested directly in equities, mutual funds and derivatives.

From just about 4.1 crore at the end of FY20, demat accounts have grown to over 15 crore at the end of March 2024 (source: https://www.moneycontrol.com/news/business/markets/investing-smart-how-retail-investors-are-making-the-most-of-topsy-turvy-markets-12744240.html). At the same time, retail investments in mutual funds have also grown by a healthy 63.5% CAGR from Rs. 4.22 trillion in March 2020 to Rs 14.9 trillion in March 2024 (source: AMFI). Newly available investment platforms that provide a smoother customer experience to investors at a lower commission have helped enhance retail interest. In fact, retail investments have often served as a counterbalance in times of global market volatility and provided stability to Indian equity markets.

Just as equity markets have benefitted from retail participation; bond markets can also benefit over time with higher retail participation. This is important from a macro financial perspective. A robust and well-functioning bond market can contribute to economic growth. It can increase the competitiveness and efficiency of the financial system by providing diversification from banks for both borrowers and investors.

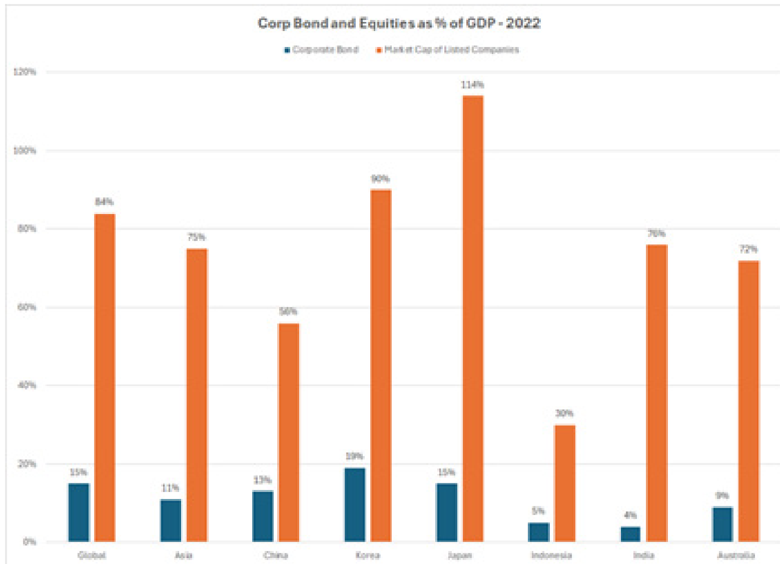
SEBI, the primary regulator of the corporate bond market, has taken significant steps over the years to improve the market microstructure for corporate bonds. Some of these steps include: settlement through delivery versus payment (DvP) mode that minimizes settlement risk, operationalisation of a trade reporting platform for enhancing transparency, introduction of an electronic bidding platform (EBP) for primary issuance, consolidation of stock through reissuance and introduction of request for quote (RFQ) platforms.

As a result, the corporate bond market (as seen in the chart below) has grown at a healthy CAGR of 13.6% to Rs. 47.3 trillion from a modest Rs. 7.9 trillion in June 2010. The corporate bond market compares favourably with the 11.5% CAGR for bank deposits during the same period (source: SEBI/Bloomberg).



Source: SEBI

While corporate bonds have grown at a healthy pace, there is still considerable potential for the bond market to expand if we compare India to other large economies. As can be seen below, while equities were largely comparable to major economies, Indian corporate bonds—as a share of 2022 GDP —were just 4% at the end of 2022 compared to 11% for Asia and 15% for the global average.



Source: OECD Capital market series dataset, Bank for International settlements, World Bank,LSEG

Moreover, retail participation in Indian bonds remains low. Compared to retail investors' share in equities turnover at 36.5% in FY23, the non-institutional share was just 4% in debt in 2023.

2024 could be the 1994 moment for Indian bonds

1994 was the year Indian equities were included on the MSCI Emerging Markets Index, which started foreign investor's interest in India's equities. Today, foreign portfolio investors own not only a significant part of Indian equities but have provided a significant depth and coverage to the Indian equity market and have contributed towards an "equity culture".

The inclusion of Indian sovereign bonds in JP Morgan GBI EM not only raises a possibility for a sustained flow of money into Indian fixed-income markets, but it can also foster more liquidity and transparency in the Indian fixed-income market. This should ultimately benefit retail fixed-income investors as well.

To encourage retail investors, SEBI has taken several measures (source: https://www.sebi.gov.in/sebi_data/meetingfiles/may-2024/1715332693805_1.pdf) in recent years to simplify bond investing like reduction in face value of debt securities to Rs. 10,000, standardisation of record dates and promotion of online bond platforms.

Opportunity for retail investors

An independent inflation targeting the central bank and a strong, investor-friendly regulatory regime have built the foundation for a healthy fixed-income market. Retail investors can benefit from the following advantages by considering direct fixed-income investing:

1) Diversification: Retail investors, over the past few years, have allocated a high proportion of their capital to high-growth but high-risk investments: in equities, derivatives and real estate. While equities can outperform inflation over longer period horizons, they can be highly volatile in the near to medium term. Fixed income instruments, although subject to interest rate and credit risk, can provide diversification as they typically have a lower correlation with equity. They also offer a relatively more stable source of predictable income.
2) Tax saving: While the interest income is taxed at a marginal rate, direct investing in bonds is also beneficial compared to other types of fixed-income instruments as long-term capital gains on bonds are 10% (without indexation) if the holding period is more than 12 months.
3) Convenience: Just like investing in equities, investing in bonds can be done directly from the convenience of homes without relying on intermediaries due to the proliferation of bond trading platforms.
4) Flexibility: Investors can also "pick and choose" their preferred issuers directly and build a portfolio as per their risk appetite, which they may not be able to do if they invest through a debt mutual fund.
5) Efficiency: One of the biggest drawbacks of investing directly in bonds in the past for retail investors has been the challenge to liquidate bond investments, unlike fixed deposits that can be liquidated, although with a penalty. However, with various bond platforms coming up, investors may be able to liquidate their holdings more easily.

Understanding the challenges

There is a study of corporate bond trades between 2002-2019 in the US by Stanford Graduate School of Business that found that retail investors who pick their own corporate bonds often base their trades on untimely or incomplete information, leading to poorer outcomes compared to investing in debt index funds.

While a favourable taxation regime, regulatory push and diversification needs from other asset classes may lead to greater retail participation in fixed income, investors may need to approach fixed-income investing with complete awareness to adequately benefit from their allocations:

1) Understanding of credit risk: As the experience with some credit-oriented mutual funds and direct investments in high-yield bonds of financial institutions reflects, many non-institutional investors are not fully aware of credit risks embedded in various fixed-income instruments. Most non-institutional investors have a background of investing in small savings schemes or scheduled commercial banks' fixed deposits, which are implicitly backed by the sovereign. Investors are typically used to selecting deposits that offer competitive yields and match them with their investment horizon. However, bonds are subject to credit risks and may face a significant markdown in case of any adverse credit event. Typically, bonds offering higher yields can be more prone to downgrades/defaults. Hence, investors not only need to understand the characteristics of the bond but also need to assess the issuer's credit profile.
2) Outsized reliance on credit ratings: While credit rating agencies are careful and comprehensive in their rating process, they operate within a framework and hence need data over a longer period to change their outlook/ rating than market dynamics. While they are a convenient and standardised metric for comparison across issuers, investors need to do their due diligence and carefully stay updated on their portfolios.
3) Management of interest rate risk: Interest rate movement can be quite volatile and depends on multiple factors like global or domestic growth/inflation outlook. The inflation outlook depends on the behaviour of global commodities market most notably oil, rainfall patterns, MSPs by the government, currency movement, etc. The growth outlook depends on private consumption, global export cycle, private sector capex, government spending, etc. While an interest rate specialist fund manager, who is tracking many of these variables, may actively manage the duration, based on an interplay of these events regularly, it may be onerous for a non-institutional investor to track these regularly and guard against volatile interest rates.
4) Understanding liquidity risk: Although bank deposits can be liquidated, they come with penalties. Mutual fund investments, on the other hand, can be bought and sold with relative ease. However, the bond market isn't always instantly liquid, and some bonds may be difficult to liquidate within a day. For example, rising interest rates generally cause bond prices to fall, which in turn can be accompanied by a bond market sell-off that might further depress bond prices. An increase in interest rates might also make it more challenging to sell a bond, especially one with a high duration, at a desirable price. Similarly, a credit stress event for a particular issuer might have a significant liquidity impact. Even in a functioning market, investors need to be aware of the bid-ask spread while executing their orders. While brokerage on direct trading might be low, a significant bid-ask spread while buying/selling bonds may lead to a meaningful return difference.

Conclusion

"The best investors do not target return; they focus first on risk, and only then decide whether the projected return justifies taking each particular risk." Seth Klarman, American investor and author.

Currently, India has the world's largest population and the youngest. The median age is around 28 years; not until the mid-2050s will aging set in. Thus, India will enjoy a demographic dividend window of more than three decades, driven by rising working-age population rates and labour force participation rates. As India tries to achieve a 7%+ GDP growth rate, there is immense potential for further investments in capital markets.

The democratising of bond markets can meaningfully deepen bond markets while helping retail investors diversify their investments. An equity-like approach to fixed-income investing may not be appropriate because of the nature of risk-reward. While equities may offer significant upside potential, bonds have limited upside potential but meaningful downside risk if invested incorrectly

Any investment requires an understanding of the primary nature of the asset class. The primary reason for investing in fixed income is to preserve one's capital and earn a stable income through a liquid portfolio.

Hence, investors should ensure that their financial strategies are aligned with their goals, risk profiles and investment horizons. Till we see reasonable maturity and depth in bond markets, retail investors may be better off seeking professional advice while investing.

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