Short Term Debt Funds – An Interesting Investment Opportunity at Higher Yields

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Sensing an expected increase in rural inflation due to increase in Minimum Support Prices (MSP) of Kharif crops, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI)announced an increase in policy rates once again. Policy rates were hiked by 25 bps and it was for the first time in five years that the rates were increased in two consecutive meetings.

The increase in the policy rates aims to make credit costlier for the borrowers, which will translate into lower demand for goods and thus lowering of the inflation. The immediate reaction on the rate hike announcement in the bond markets resulted in yields moderating a little,as the MPC maintained its neutral stance on the economic outlook and emphasised to stay data-dependent for further policy decisions. However, the yields could have cooled off in spite of the rate hike as the policy action was almost factored in by the markets.

The interest rate scenario and yields are closely interlinked. The yields adjust through the market forces to reflect the prevailing interest rates in the market. As such, the market prices of the securities and yields are inversely proportional. Accordingly, as and when the yields increase, the market price of the debt securities decrease. This inverse relationship also gives rise to the interest rate risk for investors in the fixed income market. This is due to the fact that as there is an interest rate action, market value of fixed income securities changes accordingly.

When the interest rates rise, the existing securities issued at lower interest rates become less attractive, and hence, the prices get discounted to reflect the same. Similarly, when the interest rates decrease, the debt securities issued at higher rate will now fetch premium in the market. This is how the interest rate movements impact your debt portfolio.

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The movement in the valuation of debt securities also depends upon the duration of the securities. The longer the time to maturity of the securities, higher will be the impact on valuation and yield. For example, if you have invested in a debenture of 5 years and 10 years with coupon rate of 10% by the same issuing company, the current market yields of different tenors will tend to react by different percentages, by even the same policy action. So, nearer the maturity of the debt security, lesser is the impact of the rate actions on the price and yields, as these typically converge to the face value and the coupon rate, respectively, at the time of maturity.

Having discussed about the impact of policy action on different debt securities, the impact of the policy action on debt mutual funds gets more complex to be calculated upfront. This is due to the diverse nature and duration of securities the debt funds invest in. However, with the regulatory guidance on the classification of the debt schemes, investors can choose to remain invested in funds of different durations or credit ratings as per the investment objective of the respective funds.

Debt fund managers tend to employ three diverse strategies to generate returns for their investors from the portfolio:

Accrual Strategy

Such strategy aims to earn through the accrual of interest income on debt securities. Even while the interest may be payable on periodical intervals like semi-annually, annually, etc., each passing day entitles the investor for 1-day's interest, and as such, it gets factored in the market price.

Interest Rate Movements

The portfolio can also be impacted by the interest rate movements. Lowering of the interest rates in the market will help in the capital appreciation of the prices of the securities, thereby impacting the total returns. Further, if the policy rates are expected to increase, the fund manager may hedge interest rate risk through use of derivatives or by reducing the average duration of the portfolio.

Potential Capital Appreciation through Rating Upgrades

Fund managers may also bet upon potential rating upgrades of the issuer companies for the investors to gain from the capital appreciation upon such upgrades. This is because a rating upgrade makes the debt security more attractive for investors to invest in, due to decrease in credit risk.

Given that the RBI will be dependent on data for future policy actions, interest rates are expected to be volatile in the short term. Even the possibility of a rate hike cannot be ruled out. The bond yields of short to medium term papers continue to stay elevated as compared to the prevailing yields in recent times. As a result, this segment is presenting an attractive investment opportunity. However, given the wide range of debt funds available, including varying duration funds, credit opportunities and gilt funds, one must choose the appropriate debt fund as per the risk appetite and investment horizon.

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