Corporate Bond Funds – A potential opportunity

Bank fixed deposits (FDs) have traditionally been the most favoured debt investment option among Indians. But not anymore. With interest rates on FDs falling, especially over the past one year, their popularity is waning. In such times, corporate bonds can serve as an alternative to bank FDs for investors looking for low-risk investment options.

Introduction

Also known as non-convertible debentures, corporate bonds are debt instruments issued by companies as an alternative to bank loans. Safety of corporate bonds can be evaluated from the credit ratings issued by rating agencies. Issuers with AAA rating have the highest safety and lower credit risk than those with AA rating.

Table 1: Credit ratings for different instruments

Long-term debt instruments

Rating	Credit risk
AAA	Highest safety
AA	High safety
A	Adequate safety
BBB	Moderate safety
BB	Moderate risk
B	High risk
C	Very high risk
D	Expected to default

Short-term debt instruments

Rating	Credit risk
A1	Lowest risk
A2	Low risk
A3	Moderate risk
A4	High
D	Expected to default

Note: CRISIL may apply '+' or '-' signs for ratings from 'CRISIL AAA' to 'CRISIL C' in long-term debt instruments and for 'CRISIL A1' to 'CRISIL A4' in short-term debt instruments to reflect comparative standing within a category
For illustrative purposes. Source: CRISIL

Corporates compensate investors for the credit risk on these bonds by offering higher yields compared with government bonds. Thus, lower rated bonds (AA+, AA, AA- and A+) provide higher yields and spreads over comparable government bonds and higher rated bonds (AAA), but carry higher credit risks.

Table 2: Yield matrix across rating categories

Yields (%)	G-sec	AAA	AA+	AA	AA-	A+
1 year	3.40	3.91	4.32	4.68	5.42	5.87
3 years	4.46	4.69	5.21	5.59	6.11	6.56
5 years	5.04	5.51	5.96	6.25	6.86	7.31
10 years	5.87	6.59	7.04	7.35	7.61	8.06

Source: CRISIL, Data as on 31st December 2020.

Selecting the right bond can be daunting for retail investors as they do not have sufficient skill, knowledge or the time to track the market. Instead, they can opt for Corporate Bond Funds.

How Corporate Bond Funds work

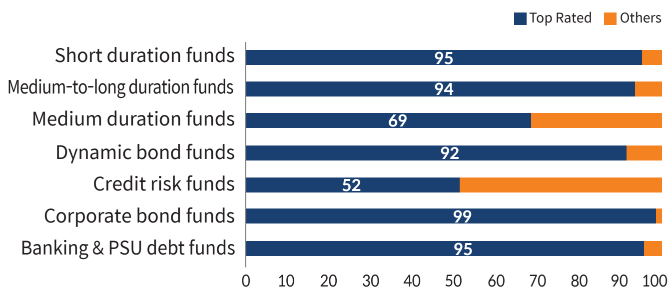
Corporate Bond Funds are debt mutual fund schemes which invest in corporate bonds or non-convertible debentures. As per SEBI's mandate, corporate bond fund must invest at least 80% of its assets in highest rated corporate bonds. Since Corporate Bond Funds invest predominantly in highest quality instruments, the credit risk of these funds is relatively lower compared to other debt funds which may invest in lower rated instruments.

Why Corporate Bond Fund?

High on safety

As Corporate Bond Funds are required to take most of their exposure in top rated debt instruments, they are high on safety compared with most other debt fund categories. A credit quality comparison between debt funds shows how strong corporate bonds are on the safety parameter. Also, Corporate Bond Funds have almost full exposure to top rated papers, the highest among debt categories.

Category-wise rating distribution



Note: CRISIL-ranked Corporate Bond Funds for the quarter ended September 2020 used for analysis

Portfolio as of November 2020. Top rated includes securities rated AAA, A1+, cash and cash equivalents, Government securities /State Development Loans (SDL) & Treasury-Bills. Others include papers rated lower than AAA and A1+. Source: CRISIL

Lower default/downgrade rate

A 10-year analysis of top rated CRISIL AAA papers reveals only a miniscule percentage of default in the papers, while it increases as one moves down the credit rating spectrum (Table 3).

Table 3: Average default Rates for long-term instruments: April 2009 to March 2020

CRISIL rating	1-year default rate	2-year cumulative default rate	3-year cumulative default rate
AAA	0.01%	0.03%	0.04%
AA	0.08%	0.22%	0.31%
A	0.21%	0.90%	1.76%
BBB	0.78%	2.02%	3.55%
BB	3.07%	6.27%	9.22%
B	6.65%	12.70%	17.37%
C	17.50%	28.55%	35.89%

Note: The default rates might vary with that of other rating agencies. For illustrative purposes. Source: CRISIL

Similarly, another analysis (Table 4) of average 1-year transition rates for long-term ratings for the past 10 financial years shows that 1.22% of CRISIL-rated AAA papers have moved down and transitioned to lower rated AA papers, highlighting the stability of top rated papers.

Table 4: Average 1-year transition rates for long-term ratings over past 10-financial years – As on March 31, 2020

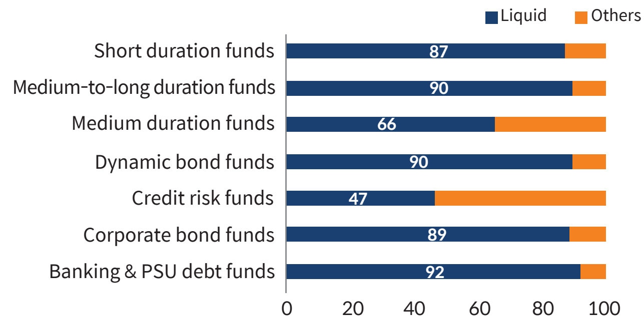
Rating	CRISIL AAA	CRISIL AA	CRISIL A	CRISIL BBB	CRISIL BB	CRISIL B	CRISIL C	CRISIL D
AAA	98.78%	1.22%	0%	0%	0%	0%	0%	0%
AA	1.38%	96.11%	2.37%	0.12%	0%	0%	0%	0.02%
A	0.02%	2.84%	92.39%	4.32%	0.19%	0.03%	0.03%	0.18%
BBB	0%	0.05%	2.58%	90.82%	5.47%	0.19%	0.07%	0.82%
BB	0%	0%	0.01%	3.91%	88.44%	3.85%	0.25%	3.55%
B	0%	0%	0%	0.04%	8.13%	83.08%	0.46%	8.28%
C	0%	0%	0.01%	0%	1.43%	19.65%	58.30%	20.62%

Note: The transition rates might vary with that of other rating agencies. For illustrative purposes. Source: CRISIL

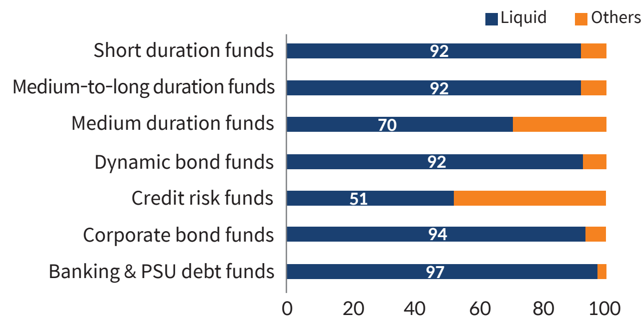
Higher Liquidity

Being heavy on top rated papers boosts the liquidity aspect of these funds, which helps the fund manager to rebalance the portfolio more efficiently. An analysis of the liquidity parameter of corporate bonds shows that about 94% of their portfolio is in short-term liquid securities, second only to banking and PSU debt funds, which have ~97% liquidity. In terms of long-term liquidity also, Corporate Bond Funds score strongly.

Allocation to long-term liquid assets



Allocation to short-term liquid assets

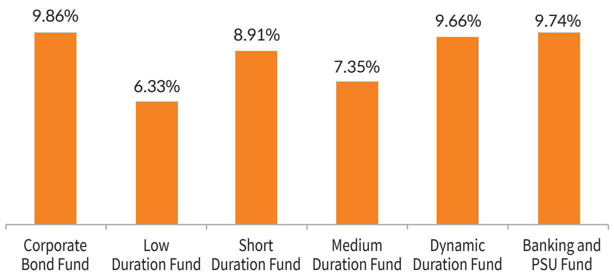


Note: CRISIL-ranked Corporate Bond Funds for the quarter ended September 2020 have been used for the analysis Portfolio as of November 2020. Liquidity classification based on CRISIL's internal model, which factors trades and spreads of issuers.
Source: CRISIL

Steady performance

Even during the recent financial market upheaval, Corporate Bond Funds have posted steady returns compared with other debt categories.

The chart below shows the 1 year average category returns of Corporate Bond Funds versus some other popular Debt Fund Categories (as 5th Jan, 2021). Please note that while liquid and ultra-short duration funds are also very popular, they are not shown here because liquid and ultra-short duration funds are primarily suitable for very short (less than 12 months) investment periods. Further please note that SEBI's current mandates for different debt categories came into force in the middle of 2018. So longer period returns at a category level may not be relevant.



Source: Advisorkhoj Research (as on 5th January 2021).
Disclaimer: Past performance may or may not be sustained in the future

Higher risk-adjusted returns

The data/performance provided above pertains to the category of scheme and does not in any manner constitute performance of any individual scheme of Mirae Asset Mutual Fund.

If we consider the risk-adjusted performance (as measured by the Sharpe ratio) of Corporate Bond Funds over 1, 3, 5 and 7year periods, they have emerged as the chart toppers in most of the periods. For instance, over the 1, 3 and 5year periods, these funds had a Sharpe ratio of 2.9, 2.64 and 2.66, respectively, as against 2.5, 2.41 and 2.55 posted by banking and PSU debt funds.

Risk-adjusted returns

Category	1 yr	3 yrs	5 yrs	7 yrs
Banking and PSU debt fund	2.50	2.41	2.55	2.72
Corporate bond fund	2.90	2.64	2.66	2.66
Credit risk fund	1.27	0.63	1.13	1.37
Dynamic bond fund	2.40	1.45	1.52	1.59
Medium duration fund	1.75	1.24	1.65	1.74
Medium-to-long duration fund	2.20	1.39	1.42	1.54
Short duration fund	2.61	2.12	2.30	2.46

Note: Data for period ended December 15, 2020.
Source: CRISIL

Tax benefit

Investing in Corporate Bond Funds for a period exceeding three years qualifies for long-term capital gains tax at 20% with indexation. This makes corporate bonds a good alternative to FDs for investors belonging to the highest tax bracket, as FD returns are taxed as per income tax slabs.

	Traditional Investment	Corporate Bond Fund
Investment	1,00,000	1,00,000
Investment Date	01-04-2020	01-04-2020
Maturity Date	31-03-2024	31-03-2024
Taxation of maturity proceeds	Income Tax Rate	20% after indexation
Assumed rate of return	6%	6%
Investment Tenure (yrs)	4.0	4.0
Number of indexation periods	N/A	4
Maturity Amount	1,26,248	1,26,248
Indexed cost of acquisition	N/A	1,16,986
Taxable income / capital gains	26,248	9,262
Tax	8,189	1,926
Post Tax Income	1,18,058	1,24,321

Source: Advisorkhoj

Corporate Bond Funds in portfolio allocation

Depending on your investment needs, your debt portfolio should have a combination of funds of different duration profiles ranging from a few months, to 2 – 3 years to longer investment tenures. Your debt portfolio should also have a combination of highly rated money market instruments, highly rated corporate bonds and G-Secs. Corporate Bond Funds are suitable for 3+ year investment tenures. If you have a 3 plus years investment tenure you can get the benefit of long term capital gains taxation in debt funds. Corporate Bond Funds can be part of your core debt fund portfolio. These funds may provide stable returns, with limited downside risk and higher post tax returns over sufficiently long investment tenures. These funds can give good returns in different interest rate scenarios if you have sufficiently long investment tenures, provided your tenure matches with the duration profile of the fund.

Who should invest?

- **Investors who aim for stable returns and want to avoid credit risks**
- **Investors who have moderate risk profiles**
- **Investors who have at least 2 – 3 years investment tenures**
- **If you can remain invested for 3 plus years, you can enjoy benefits of long term capital gains taxation**

Investors should consult with their financial advisors if Corporate Bond Funds are suitable for their investment needs.