An Investor Education Initiative

MIRAE ASSET

Mutual Fund

by Mirae Asset Knowledge Academy

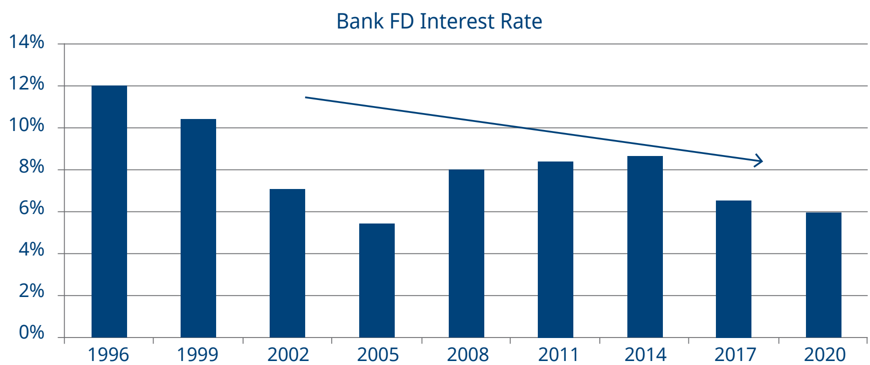
DEBT MUTUAL FUND - A STABLE AND STEADY INVESTMENT CHOICE

1 - Traditional Fixed Income instruments

Bank fixed deposits and Government small savings schemes have been the traditional investment choice of average Indian households. As per Reserve Bank of India's Quarterly Estimates of Household Financial Assets and Liabilities, Rs 4,753 billion was invested in bank FDs in FY 2018 (latest year for which data is available from RBI). On the other hand, despite its growing popularity, share of mutual funds in household fixed income assets is still relatively quite small. As per AMFI data (February 2020), retail and HNI net investment in debt mutual funds in the last one year (ending Feb 2020) was Rs 260 billion.

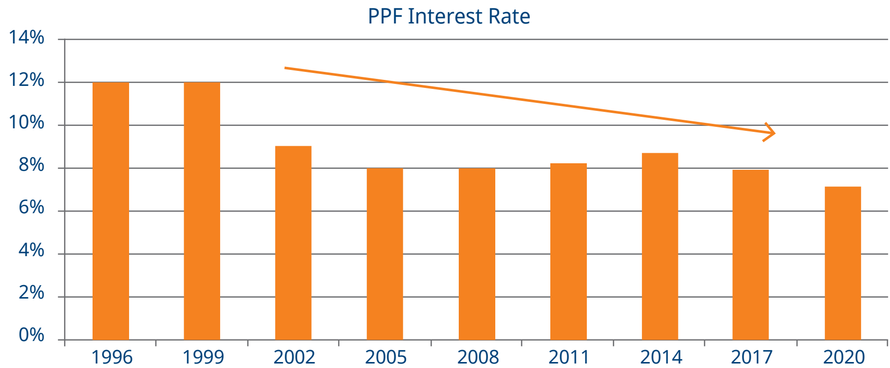
FD and small savings schemes' interest rates on declining trend

Bank FD interest rates have generally been declining over the last 20 years, from 10 – 11% in 1999 to just around 6% in 2020.



Source: Advisorkhoj Research based on historical SBI interest rates (quarterly rates are averaged)

Similarly, Government (Post Office) small savings schemes' interest rates are also on a declining trend over the last 20 years from 12% to around 7% in 2020.



Source: Advisorkhoj Research (quarterly rates are averaged)

The Government has already announced cut in interest rates of small savings schemes. In the long term also, we may see further decline in interest rates as inflation goes down in our economy.

2 - Debt Mutual Fund Schemes

Different investors have different investment needs depending on their financial situations, risk appetites and investment objectives. Debt mutual funds offer a spectrum of solutions for a wide range of investment needs, risk appetite and investment tenures. We will discuss about some key debt fund categories below.

Overnight Funds

These debt funds invest in fixed income instruments which mature overnight. These instruments have virtually no interest rate risk. These overnight instruments are backed by collateral which comprises of Government Securities, and so these funds also have no credit risk. These are the safest debt funds but their yield is usually also the lowest. Overnight funds are suitable for parking your funds for a few days.

Liquid Funds

Liquid funds invest in debt and money market instruments like commercial papers, certificates of deposits, treasury bill etc which mature within 91 days. Due to the very short maturities of their underlying instruments, liquid funds have very low interest rate risk. However, liquid funds may have exposure to credit risk depending on the credit quality of the underlying instruments. High credit quality liquid funds have very low risk and potentially offer higher returns than savings bank. According to SEBI directive, these funds charge graded exit loads for withdrawals within 7 days from the date of investment. Liquid funds are suitable for parking your funds for a few weeks or months.

Money Market Fund

As per SEBI's mandate, Money Market Funds must invest in money market instruments like commercial papers (CPs), certificates of deposits (CDs), treasury bills (T-Bill) etc., having maturity of less than 1 year. These funds have moderately low price sensitivity to interest rate changes. However, these funds may be subject to credit risks depending on the credit quality of the underlying instruments of the funds. These funds are suitable for investors with moderately low risk appetites. Investors should have 1 – 2 year investment tenures for these funds.

Short duration Funds

Short duration funds invest in debt and money market instruments such that the Macaulay Duration of the portfolio is between 1 – 3 years. In simplified terms, Macaulay Duration is the interest rate sensitivity of a fixed income instrument. Due to their relatively short duration profiles, short duration funds have medium interest rate risk. These funds aim to hold the instruments in their portfolio till maturity and earn interest paid by them, aiming to give stable returns in different interest rate scenarios. Some funds can have exposure to credit risk depending on the credit quality profile of their underlying instrument. Short duration funds are suitable for 2 – 3 year investment tenures. Investors can avail of long-term capital gains tax benefits for 3 years + investment tenures.

Corporate Bond Fund

As per SEBI's mandate, Corporate Bond Funds must invest at least 80% of their total assets in highest rated instruments. The highest rating given by agencies like CRISIL and ICRA for corporate bonds is AAA and for short term instruments i.e. instruments with maturity of 1 year or less e.g. commercial papers, certificates of deposits etc is A1. Corporate bond funds must invest 80% of their assets in such instruments. Even though AAA and A1 denote highest degree of safety, ratings can change over time depending on the financial performance of the issuer. Investors should monitor the credit quality profile of their funds on a regular basis.

Credit Risk Fund

As per SEBI's directive, Credit Risk Funds invest at least 65% of their total assets in instruments which are rated below the highest rating. In other words, AA or lower (corporate) and A2 or lower for short term instruments i.e. instruments with maturity of 1 year or less e.g. commercial papers (CP), certificates of deposits (CDs) etc. Lower rated papers give higher yields but also have higher credit risks. Investors should understand the risks in these funds before investing.

Dynamic Bond Funds

Dynamic bond funds have the flexibility to invest across durations depending on their interest rate outlook. If the fund manager expects interest rates to fall, he / she will invest in longer duration instruments to benefit from price appreciation. Likewise, if the fund manager expects interest rates to rise, he / she will invest in shorter duration instruments to get higher yields and reduce interest rate risk. Dynamic bond funds usually have high sensitivity to interest rate changes. Investors should have appetite for short term volatility and a sufficiently long investment horizon. Investors should have at least 3 years or longer investment horizon for these funds. Over investment tenures of 3 years or longer, you can get long term capital gains tax benefits. Investors can use SIP to reduce volatility which may also improve returns of the fund.

Gilt Funds

These funds invest at least 80% of their assets under management in Government Securities. Hence these funds have very low credit risk. However, these funds have high sensitivity to interest rate changes. They can give high returns when yields are falling but can be quite volatile in the short term if yields spike due to any reason. Investors should have high appetite for volatility and at least 3 years or longer investment tenures for their Gilt fund investments.

Long Duration Income Fund

As per SEBI's mandate, Long Duration Funds must invest in debt and money market instruments such that the Macaulay Duration of the fund portfolio is greater than 7 years. The Macaulay duration is the weighted average term to maturity of the cash flows from a bond. Macaulay duration is closely related to Modified Duration which is the price sensitivity of a fixed income instrument to interest rate changes. Long duration income funds are highly sensitive to interest rate changes. However, long duration funds usually have relatively low credit risk because these funds invest predominantly in G-Secs. Since these funds have fairly high interest rate risk, investors should have moderate risk appetites and sufficiently long investment tenures (at least 3 years).

3 – Factors to consider before investing in Debt Mutual Funds?

Fixed Income or Debt funds offer a greater variety of products across the risk / return spectrum. It is, therefore, important for investors to select the right product according to their specific investment needs, risk appetite and investment tenure. Before we discuss how to choose the right debt fund, we should understand the two main risk factors in debt funds:

Interest rate risk: Prices of fixed income securities are inversely related to interest rate changes. If interest rate goes up, price decreases and vice versa. Different fixed income instruments have varying price sensitivities to interest rate changes. Price sensitivity to interest rate change is also known as duration. Longer the duration of an instrument higher is the sensitivity to interest rate changes.

Credit risk: This refers to risk of default i.e. failure to pay interest and / or the principal by the issuer of the fixed income instrument. Rating agencies assess the credit risk of fixed income instruments based on the financial strength of their issuer and assign credit rating to instruments. If credit rating of an instrument gets downgraded, the price of instrument will fall. Likewise, if the credit rating gets upgraded, the price will rise.

Interest rate risk is temporary while credit risk is permanent

Price of a fixed income instrument will fall if interest rate goes up. However, interest rate movements are always in cycles – periods of rising interest rates are followed by periods of falling rates. If you have a long investment horizon, you will be able to ride out the volatility due to interest rate changes. However, if the issuer defaults on interest and maturity payments then the price of the instrument will be written down permanently. Therefore, credit risk is often permanent and investors should aim to minimize this risk.

How will you know the credit quality of your scheme?

AMCs disclose the credit rating profile of assets for all their fixed income funds in their monthly factsheets. You should refer to these factsheets to understand the credit quality of the fund before making investment decisions.

Selecting funds based on risk appetite

Investors should understand that risk and return are directly related. Your returns expectation should be commensurate with the risk profile of your investment. Investors should be aware of the linkage between investment tenure and risk capacity (especially interest rate risk). Shorter the investment tenure, lower the interest rate risk capacity and vice versa.

Very short duration funds like overnight and liquid funds have very low interest rate risk but their average returns are likely to be lower than debt funds with longer duration profiles. Short duration and medium duration funds have moderately low to moderate interest rate risk. Their average returns are usually higher than liquid funds over a sufficiently long tenure but lower than funds which have even longer duration profiles. Dynamic bond fund and Gilt funds have the potential of giving high returns but they can be quite volatile in the short term. You should select funds according to your risk appetite.

Funds which invest in lower rated instruments (higher credit risk) can give higher returns than funds with high credit quality profiles because lower rated instruments give higher yields than highly rated instruments. But you should be aware of the risk you are taking. Unlike interest rate risk, which can be mitigated by extending your investment tenure (period of rising interest rates are usually followed by period of lower interest rates), credit risk is permanent - if the issuer defaults, then your loss is permanent. In the current economic environment, credit risk is much more dangerous. You should understand the credit risk of your investment and make informed decisions.

Selecting funds based on investment tenure

As mentioned earlier investment tenure influences your risk capacity. You should try to match the duration profiles of your investment with your investment tenure. For very short investment tenures (few days / weeks / months), you should invest in overnight funds or liquid funds. For 1 – 3 year investment tenures, you can invest in short duration funds or similar funds whose duration profile is less than 3 years. For 3 years plus investment tenures you can invest in dynamic bond funds and Gilt funds.

4 – Why invest in Debt Mutual Funds?

Debt funds can give higher returns

Debt funds are fixed income mutual fund schemes which invest in debt and money market instruments like CPs, CDs, Corporate Bond, T-Bills, G-Secs etc. These instruments pay interest (coupon) at pre defined intervals and the face value (principal) upon maturity. The yields of many of these instruments are usually higher than bank FD interest rates of similar maturities. Yields of AAA rated corporate bonds can be 150 – 200 bps higher than FD interest rates. In addition to higher yields, since these instruments are traded in the market, you can benefit from price appreciation.The chart below shows the trailing returns of different debt fund categories over different tenures.

Based on historical data, you can see that across different product categories (risk profiles) and investment tenures, debt funds have the potential to give better returns than bank FDs.

Debt Fund Category	1 year returns	3 year returns	5 year returns	10 year returns
Liquid funds	5.72%	6.42%	6.75%	7.43%
Ultra-short duration funds	6.51%	6.48%	7.12%	7.94%
Money market funds	6.98%	6.98%	7.29%	7.93%
Short duration funds	4.21%	5.55%	6.69	7.58%
Corporate bond funds	7.88%	6.94%	7.51%	7.72%
Dynamic bond funds	7.95%	6.11%	7.05%	8.13%
Gilt funds	12.73%	7.58%	8.17%	8.63%

Source: Advisorkhoj Research, Data as on 1st April 2020, returns are average for each category, returns over 1 year periods are annualized.

Past performance may or may sustain in future. The returns shown above are returns of the category and do not in any way depict the performance of any individual scheme of any Fund.

Debt funds are tax efficient

Bank FD interest is taxed as per the income tax rate of the investor. Capital gains in debt funds held for over three years are taxed at 20% after allowing for indexation benefits. Indexation benefits can reduce tax obligations substantially for investors in higher tax brackets.

Incidence of taxation in fixed income funds arise only if you redeem (sell) your mutual fund units or if you receive dividends. Capital gains on your redemption proceeds and dividends are taxed differently.

Capital Gains Tax

There are two kinds of capital gains in fixed income funds:-

Short term capital gains: If units of fixed income funds are sold within 36 months from the date of purchase then capital gains arising out sale of units will be treated as short term capital gains for tax purposes. Short term capital gains are added to your income and taxed according to your income tax slab rate.

Long term capital gains: If units of fixed income funds are sold after 36 months from the date of purchase then capital gains arising out of sale of units will be treated as long term capital gains for tax purposes. Long term capital gains are taxed at 20% after allowing for indexation benefits.

Illustration of Long Term Capital Gains

Assumptions	
Number of units	1000
Purchase NAV	100
Purchase date	01/03/2017
Redemption NAV	125
Redemption Date	15/03/2020
Surcharge	10%
Cost of Inflation Index (CII)	
CII – FY 17	264
CII – FY 20	289
Tax Calculations	
Indexed Cost of Purchase / Unit: Purchase NAV X (CII FY 20 / CII FY 17)	109.5
Redemption NAV / Unit	125
Capital Gain / Unit: (Redemption NAV - Indexed Cost)	15.5
Total Capital Gains after indexation: (Capital gain per unit X Number of units)	15,530
Actual capital gains: (Redemption NAV – Purchase NAV) X Number of units	25,000
Capital Gains tax @ 20% (plus surcharge & cess)	3,553
Effective tax rate	14.2%

*Tax calculation is purely illustrative. Please consult your tax consultant for your personal tax calculations

If you received the same maturity amount from a bank FD, then your tax outdo would have been Rs 8,280 if you were in the 30% tax bracket (plus surcharge & cess). The long term capital gains tax in the example above is nearly 60% less.

Dividend Tax

Prior to this financial year, mutual fund dividends were tax free in the hands of the investors but the scheme (AMC) had to pay dividend distribution tax (DDT) at the rate of 29.12% for debt funds before paying dividends to investors. In this Union Budget, the Government has abolished DDT. Dividends will now be added to your income and taxed as per your income tax slab. If you are in the 30% tax bracket, your post tax dividend will now be lower (assuming same dividend payout rate per unit), but if you are in the lower tax brackets your post tax dividends will be higher. You should decide whether to invest in growth or dividend re-investment option depending on your individual tax situations.

5 - SIP in Debt Mutual Funds

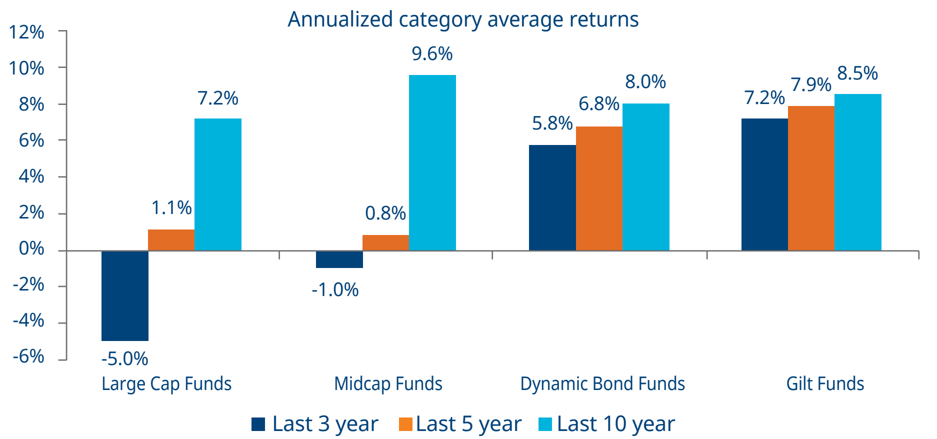
How does SIP in Debt mutual funds work?

By investing a fixed amount every month (or any other interval) from your regular savings, you can invest over a long period of time and benefit from the power of compounding. Power of compounding does not only work for equity, it also works for fixed income over long investment tenures.

By investing a fixed amount at regular intervals (monthly or any other), you will be investing at various price points and average out your purchase cost. This is known as Rupee Cost Averaging. Since fixed income funds are market linked schemes their prices are also subject to volatility (albeit lesser than equity funds). Through SIP you can take advantage of volatility even in fixed income funds especially in longer duration fund which are more sensitive to interest rates.

Fixed income can outperform even in the long term

Extreme market conditions often challenge popularly held views. One view is that equity always outperforms in the long term. This is largely correct because historical data shows that, equity has been best performing asset class in the long term. However, conventional thinking about what constitutes long term is now being challenged. The chart below shows the annualized average returns of some equity and fixed income categories over the last 3, 5 and 10 years. You can see that in certain market conditions, fixed income funds can outperform equity even over fairly long tenures.



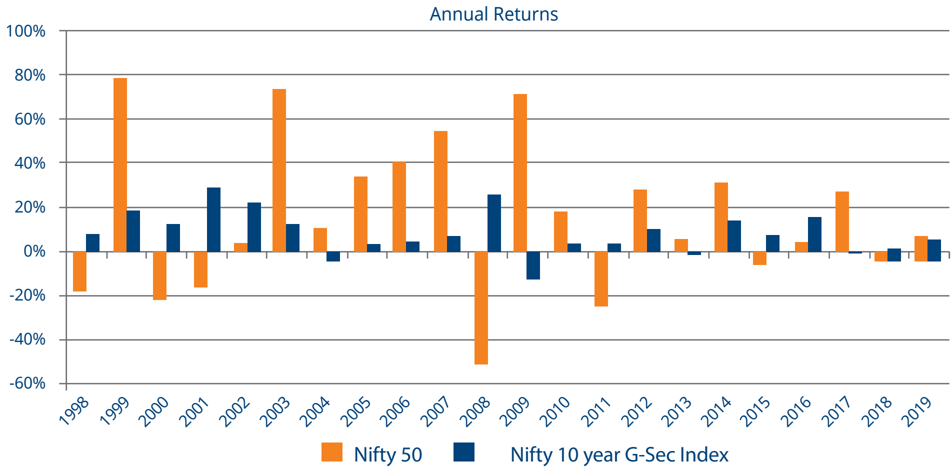
Source: Advisorkhoj Research, 31st March 2020

Past performance may or may sustain in future. The returns shown above are returns of the category and do not in any way depict the performance of any individual scheme of any Fund.

6 - Debt Mutual Funds - Myth versus Reality

Myth: Debt mutual funds are as risky as equity

The risk of fixed income instruments is usually lesser than equity because issuer of fixed income instruments is contractually obliged to pay a certain rate of interest and principal on maturity of the instrument. The management of a company has no such obligations to pay the Dividend to the shareholders, ie only when there is profit and the Management decides to share the profits among their Shareholders the Management proposes to the Shareholders to declare dividends. Dividends are distributed after paying interest and taxes.In debt instruments, there is a possibility of issuers not being able to meet their debt obligations. If a company goes into bankruptcy and its assets liquidated, bondholders are paid before shareholders. Further, usually most of the underlying instruments in longer duration debt funds are G-Secs, which have probably no credit risk because they have sovereign guarantee. Purely from the point of view of underlying instruments, fixed income funds are less risky than equity. Even if you take interest rate risk into account,longer duration fixed income funds are less risky than equity. The chart below shows the annual returns of Nifty 50 versus Nifty 10 year G-Sec Index over the last 20 years.

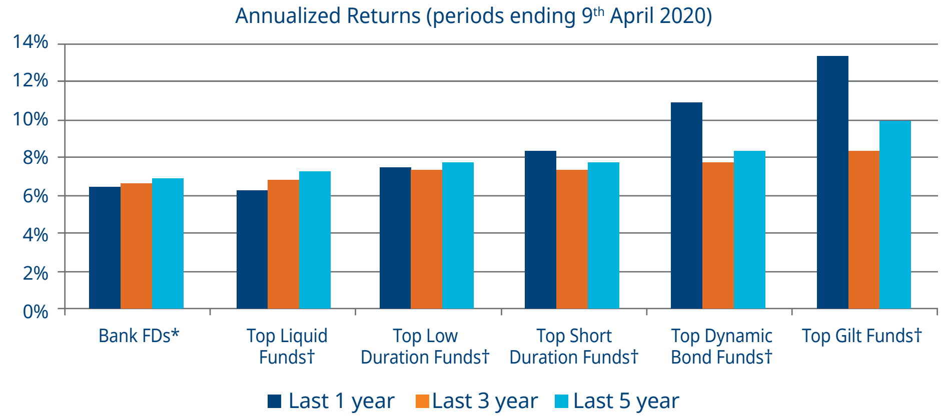


Source: NSE, Advisorkhoj Research, 1st april 2020

Past performance may or may sustain in future.

Myth: Fixed deposit usually give higher returns

The reality is that on an average and over a period of time, well managed debt funds have been able to outperform fixed deposits. Fixed deposits are seen as risk free investments. Investors should understand that risk free investments usually give the lowest returns. The yields of many fixed income instruments are higher than bank FD interest rates of similar maturities. Yields of AAA rated corporate bonds can be 150 – 200 bps higher than FD interest rates. The chart below shows bank FD returns versus top performing (top quartile) fixed income fund returns across different categories and periods. You can see that the top performing debt funds were able to outperform FDs on average (across different categories) over time.



Source: Advisorkhoj Research, * Average 1 year SBI FD interest rates, † Top quartile (top 25%) of fixed income funds in each category

Past performance may or may sustain in future. The returns shown above are returns of the category and do not in any way depict the performance of any individual scheme of any Fund.

Myth: Invest in the debt funds aiming highest returns

Different types of debt funds have different risk characteristics. There are two main risk factors in debt funds – interest rate risk and credit risk. Longer the duration of a fund, higher is its price sensitivity to interest rates, e.g. Gilt and dynamic bond funds are highly sensitive to interest rate changes while liquid and overnight funds have very little sensitivity to interest rate changes. Similarly funds which invest predominantly in Government and highly rated papers have much less credit risk than funds which invest in lower rated papers to capture higher yields.

Point to point returns in debt funds are driven largely by the interest rate and credit environment. For example, you should not select debt funds purely on the basis of recent returns. You should always invest according to risk appetite and investment needs and if need be consult your financial advisor before investing.

Source: Advisorkhoj Research as of 1st April 2020

Myth: Liquid funds seek positive return

Historically, liquid funds has sought potential returns. These funds invest in money market instruments like CPs, CDs, and Treasury Bills etc. CPs and CDs are unsecured money market instruments and only issuers with strong financial standing are able to get investors investing in such money market instruments. However, events over the past 30 months or so have shown that some liquid funds can give negative returns over certain periods. This has opened the eyes of many investors who were earlier blissfully unaware of credit risks in liquid funds. Investors should check the credit quality profile and investment track record of liquid funds before investing among other factors to be considered while investing.

Source: Advisorkhoj Research

Myth: Debt funds are meant for corporate and institutions, isn't it?

While corporate and institutions account for a very large percentage of debt fund assets under management (AUM), these funds offer excellent investment solutions to retail investors for a variety of investment needs and risk appetites. You do not need huge sums of money to invest in debt funds – you can start with just Rs 5,000. You can also invest in debt funds through SIP. Apart from investing for your short term, medium term and long term investment goals, debt funds are also useful for asset class diversification and reducing the risk profile of your investment portfolio.

7 - Key Fixed Income Terms

If you read about fixed income investments in fund factsheets, scheme information documents, fund manager interviews, blogs, etc you will come across some technical terms which you may not understand. Here we will try to briefly explain and demystify some key fixed income terms, so that you have a better understanding of fixed income as an asset class.

Repo rate: This is the rate at which the RBI lends money to commercial banks if they are facing funds shortfall. RBI uses repo rate to control inflation. If RBI increases repo rate, it is a signal for banks to increase lending rates and vice versa. It is therefore, the key interest rate of the economy.

Maturity: The maturity of a fixed income instrument is the date on which the issuer repays the principal (face value of the instrument) to the investor. The issuer will also make periodic interest payments (coupon) during the maturity term. The maturity of a debt fund is weighted average maturities of the individual instruments in the scheme's portfolio.

Yield to Maturity (YTM): YTM of a fixed income instrument is the yield (return on investment) if you buy the instrument at its current price and hold it till its maturity. When calculating yields, both interest payments (coupons) and principal payment (face value) on maturity must be taken into consideration. YTM can change over time depending on interest rate movement – as interest rates rise, YTM will also rise and vice versa. YTM of a debt fund is weighted average YTMs of individual instruments in the scheme's portfolio.

Duration: Modified Duration or simply duration is the interest rate sensitivity of a fixed income instrument. For example, if the duration of an instrument is 3 years, then for every 1% fall in interest rate, the price of the instrument will rise by 3% and vice versa. Duration is related to maturity i.e. longer the maturity, longer the duration.

Credit Rating: Credit rating is a measure of the creditworthiness, in other words, the financial ability of the issuer to meet interest and principal payment obligation. Credit ratings are assigned by specified agencies like CRISIL, ICRA etc. Credit rating of an instrument may change over time, depending on improving or worsening financial strength of the issuer. If the credit rating of an instrument gets downgraded, its price will fall and vice versa.

Non convertible debentures: Non convertible debentures (NCD) are long term debt instruments issued by companies to raise funds. They are also commonly known as corporate bonds. Please note that unlike convertible debentures, NCDs cannot be converted to equity. NCDs pay fixed interest (coupon) and principal (face value) on maturity. The interest paid by NCDs is usually higher than Bank FDs.

Commercial paper: Commercial papers (CPs) are short term fixed income instruments issued by companies to meet working capital or other short term funding requirements. CPs have maximum maturities of one year. CPs are usually issued at a discount to face value and you will get the face value on maturity. Since CPs are unsecured instruments, they usually pay higher interest than secured bonds.

Gilts: Government securities (G-Secs) are also known as Gilts. Like other bonds, Gilts have fixed maturities, during which they pay interest (coupons) and principal (face value) on maturity. Since they are issued by the Government, Gilts have no credit risk but long term Gilts have high interest rate sensitivity due to their long durations.

Yield curve: Yield curve is a line chart showing yields of bonds (usually G-Secs) of different maturities. Usually, longer the maturity of a bond, higher is its yield. Therefore, the most common shape of the yield curve is upward sloping. However, from time to time, the yield curve can also be downward. Fund managers use yield curve to adjust their investment strategies.

Indexation: With indexation, the investor is allowed to adjust the price of purchase to reflect inflation for capital gains tax. For example, if you invested in a debt fund in FY 2016 at a NAV of Rs 100 and sold it in FY 2020 at a NAV of Rs 125, you will be allowed to adjust your purchase NAV by a factor of 1.137 (ratio of cost of inflation index in FY 2020 and FY 2016) and your adjusted purchase price will be Rs 113.7. Long term capital gains (held for more than 3 years) in debt funds are taxed at 20% after indexation.

Email Us customercare@miraeasset.com | Call Us 1800-2090-777 (Toll Free) Mon-Sat: 9 a.m. to 6 p.m. | Internet www.miraeassetmf.co.in | Twitter @MiraeAsset_IN | Facebook MiraeAssetIN | Contact your financial advisor for details