Mirae Asset Knowledge Academy

Profit from Knowledge

Manage interest rate uncertainty via Dynamic Bond Funds

Debt funds have emerged as a good investment avenue for investors. However, to reap optimum returns one has to invest as per the interest rate trend. For instance in calender year 2016, the 10-year benchmark G-sec yield has fallen 124 basis points owing to the Reserve Bank of India's (RBI's) monetary easing and the demonetisation move, benefitting long-term debt funds; gilt and income funds returned 15.58%* and 11.84%*, respectively, during this period. Rewind to calendar year 2013: when G-sec yield was up by 77 bps, short-term debt funds benefitted and returned 8.02%*, while gilt and long-term debt funds returned only 3.04%* and 5.20%*, respectively. Moving between categories at the opportune moment is not only difficult for a retail investor but also costly. An easy solution is investing in dynamic bond funds, wherein professional fund managers backed by research are able to tactically manage the portfolio in line with the underlying interest rate environment.

*Value research scheme category.

Dynamic Maturity play

Dynamic bonds funds, as the name suggest, dynamically alter allocations between long-term and short-term bonds to take advantage of the direction of interest rates. These funds increase and decrease the portfolio's duration to take advantage of the direction of interest rates. Change in portfolio average maturity by these funds (as per CRISIL classification) in the wake of changes in interest rates (represented by CRISIL 10 Year Index Yield) can be seen in chart 1. The latest scenario of interest rate volatility presents an opportunity for fund managers to make tactical calls in their portfolio to maximise the benefit for their investors.

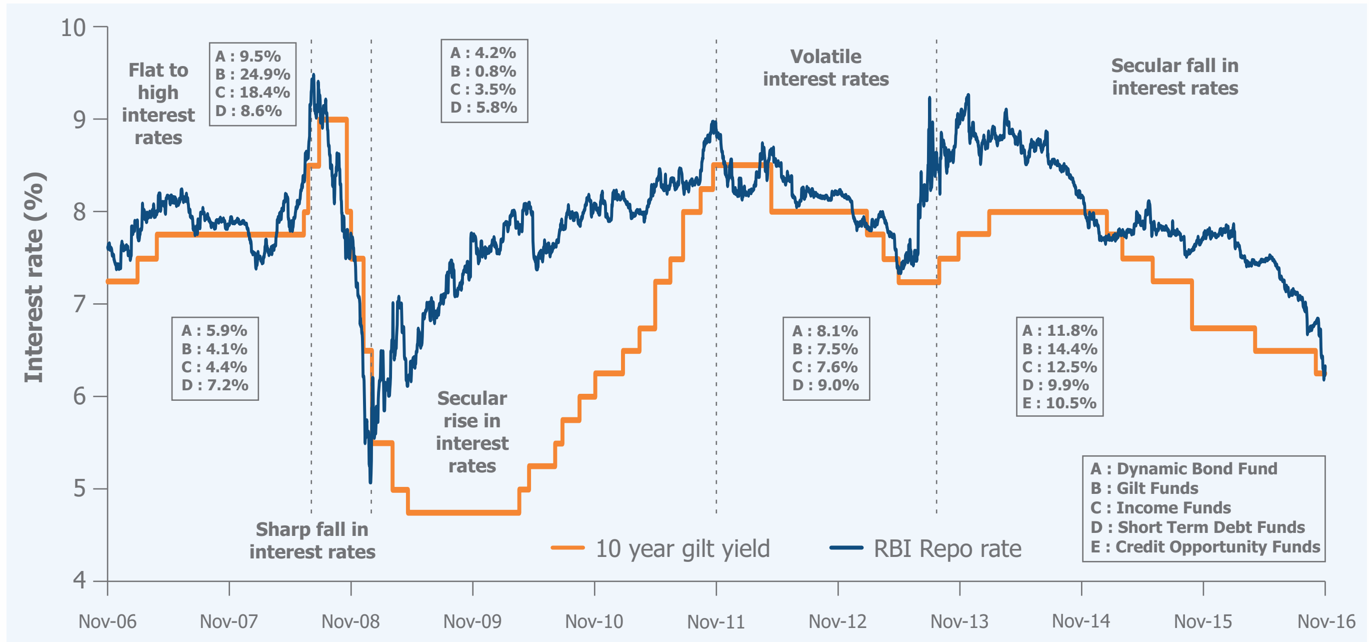
Chart 1: Average maturity by dynamic bond funds

Month-end yield values are considered for representation purpose. Data as on 30th November, 2016.

Performance is commensurate

The tactical approach has helped dynamic bond funds to maneuver the interest rate movment successfully over different phases to benefit the investor. As seen in the chart 2, these funds performed better than short-term debt funds and near-to-long maturity debt funds when interest rates fell, and better than income funds and close to short-term debt funds when rates rose. Thus, by moving across maturities, they have given commensurate returns across the interest rate cycle.

Chart 2: Market performance

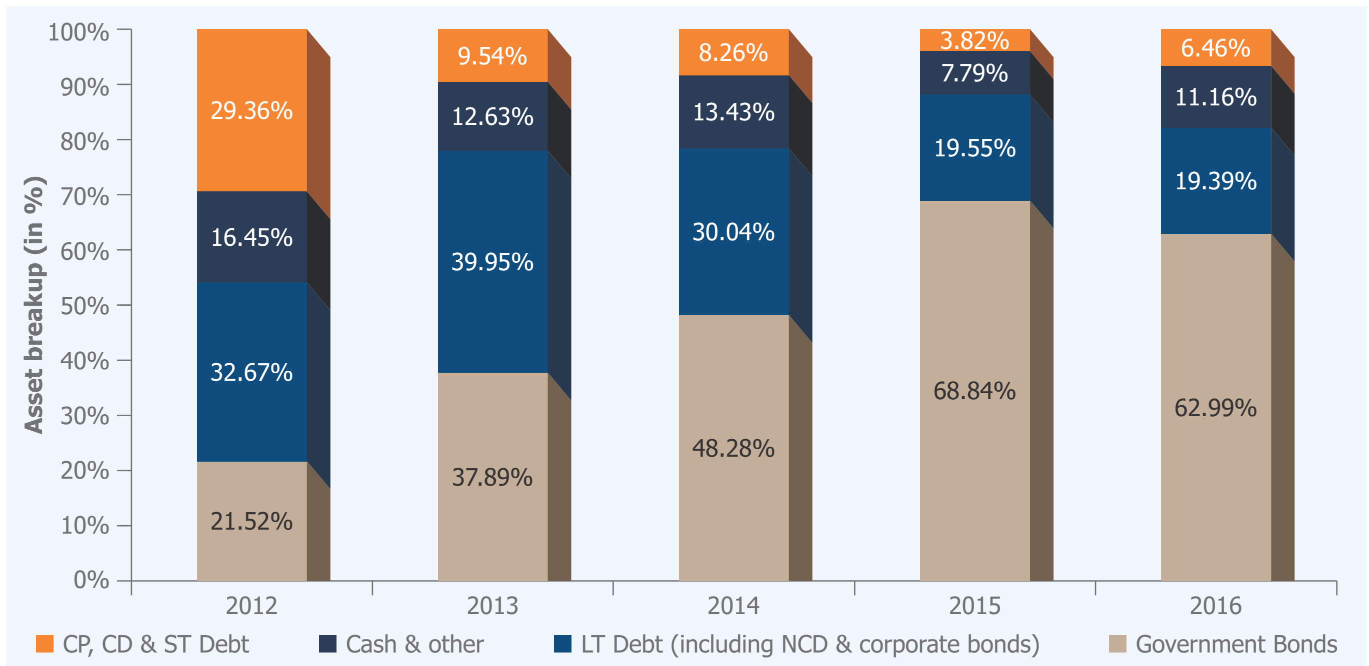


Returns are absolute for less than one year otherwise annualised. Dynamic bond funds category as per CRISIL classification. Other categories as per CRISIL Mutual Fund Ranking of September 2016. Income funds excludes dynamic bond funds 10-year gilt yield represented by CRISIL 10 Year Index Yield.
Data as on 30th November, 2016.

Portfolio mirrors investment strategy

True to its nature, dynamic bond funds are also flexible in changing the asset mix across debt instruments in tandem with the changing interest rate scenario. As seen in chart 3, these funds have gradually decreased exposure to long-term debt and increased exposure to gilts in the past five years. Tactical changes in allocation are also demonstrated via exposure to commercial papers, certificates of deposit and short-term debt funds. For example: allocation to these instruments was reduced sharply from 29% in 2012 to 4% in 2015.

Chart 3: Asset mix

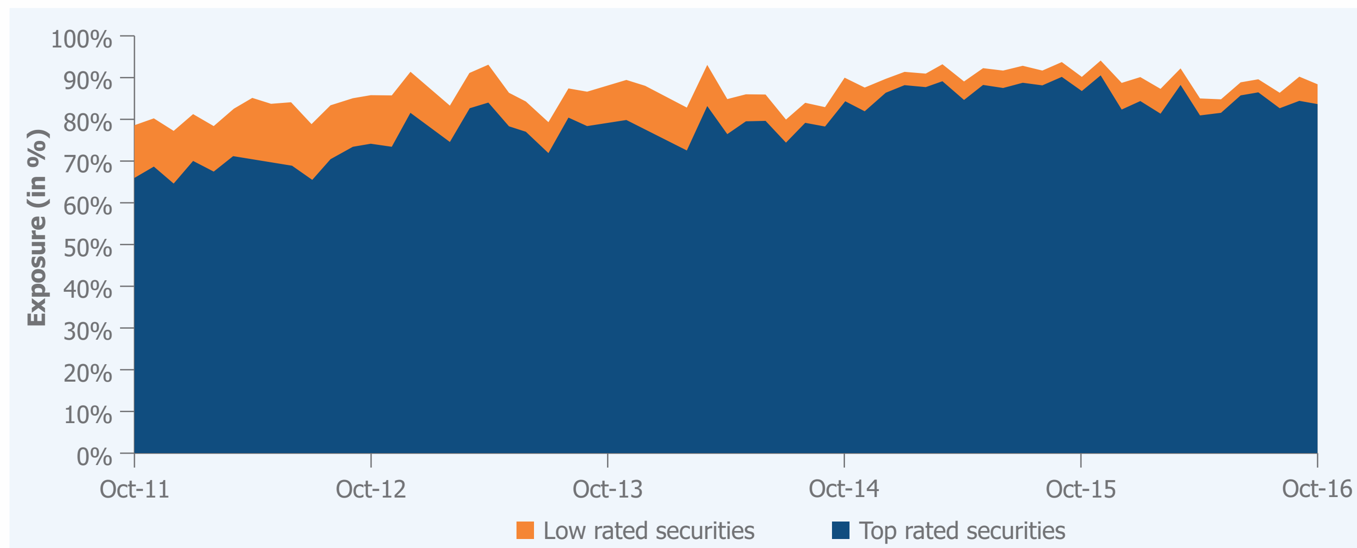


LT: Long Term ST: Short Term

Above data is average exposure YTD till 31st October, 2016.

On the rating front, in the portfolio these funds focus on high quality debt (which includes top rated AAA rated long-term papers, A1+ rated short-term papers and sovereign securities). A five-year analysis shows these funds, on average, have maintained 80% exposure to top rated debt. The high quality portfolio is generlly much more liquid than a low quality portfolio, enabling dynamic bonds to exit and invest across maturities easily and benefit from the interest rate movement.

Chart 4: Credit quality



Top rated debt includes bonds having rating AAA (long term), A1+ (short term) and GOI Low rated debt includes bonds having rating of AA (long term) and A1 (short term) and below. Data as on 31st October, 2016.

Summing up

It is difficult for retail investors to predict and take a call on interest rates. Dynamic bond funds fill this lacuna as fund managers take the call and tactically manage interest rate risk in an endeavor to earn reasonable returns. However, investors must note that the fund manager's call can go wrong at times leading to underperformance. Hence, checking the track record of the fund house and the fund manager is important in selecting a good fund.

Investors can also safeguard their investments from volatility emanating from interest rate movement by investing regularly via Systematic Investment Plans (SIP) instead of lump sum investments. This strategy will help earn stable returns along with benefits of rupee cost averaging.

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Source: All the chart & graph in the above leaflet is provided by CRISIL.

Mutual Fund investments are subject to market risks, read all scheme related documents carefully

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