Ample liquidity makes duration funds attractive

RBI has taken a number of measures to boost liquidity

NEELASRI BARMAN
Mumbai, 26 September

Fund managers are expecting higher returns from duration funds, amid falling interest rates. Short-term rates could fall further due to comfortable liquidity in the system, making liquid funds an unattractive investment option over duration funds.

Duration is measured in years. This means funds investing in instruments with higher maturity tenure are expected to perform better. "Investors will benefit more if they invest in duration funds and it is not at all late to do so," said Suyash Choudhary, head, fixed income, IDFC Mutual Fund. Duration funds invest in bonds and gilts. As interest rates are expected to drop further, the price of bonds and gilts will rise and this will boost the Net Asset Value (NAV) of duration funds.

Beginning this financial year, the rates on short-term instruments such as Certificates of Deposit (CDs) and Commercial Paper (CP) have dropped 100-200 basis points (bps), as the Reserve Bank of India (RBI) took a number of measures to boost liquidity. These include Open Market Operations, a cut in the Statutory Liquidity Ratio and the Cash Reserve Ratio (CRR). Liquid funds invest a significant corpus in CDs and CP.

According to Dwijendra Srivastava, head of fixed income, Sundaram MF, the CD and CP rates could move up by 15-20 bps in this festival season. But no sharp rise is expected. "Overall liquidity may tighten because of the festival season. Cash leakage worth ₹30,000-40,000 crore might happen this festival season. This leakage is basically withdrawals from banks by the public. But RBI will inject liquidity either by way of further CRR cuts or OMOs," said Srivastava. The Street expects the liquidity deficit to be maintained around RBI's comfort level of one per cent of Net Demand and Time Liabilities of banks through the rest of the year.

Srivastava said intermittent volatility might be higher in duration funds but the investor can expect better performance over about six months, due to falling interest rates.

Earlier this year, RBI had cut the repo rate (at which it lends to banks) by 50 bps, to eight per cent. The Street is expecting a further cut of 50 bps in the rate by end-March 2013.

However, the timing is not certain. "We expect the 10-year benchmark gilt yield to drop to 7.75 per cent some time in the fourth quarter of this year. Corporate bond yields might also drop by 30-35 bps.

This will boost the NAV of duration funds. Investors with at least a year's investment horizon can invest their incremental money in duration funds," said K Ramanathan, chief investment officer with ING Investment Management.

HOPE RETURNS

- Duration is measured in number of years. This means funds which invest in instruments with higher maturity tenure are expected to perform better
- Duration funds invest in bonds and gilts
- As interest rates are expected to drop, the price of bonds and gilts will rise, which in turn will boost the net asset value of duration funds
- Rates of certificates of deposit and commercial paper are expected to move up by 15-20 basis points this festive season

The Street expects liquidity deficit to be maintained around RBI's comfort level of 1 per cent of net demand