Income, dynamic bond funds to gain from monetary easing

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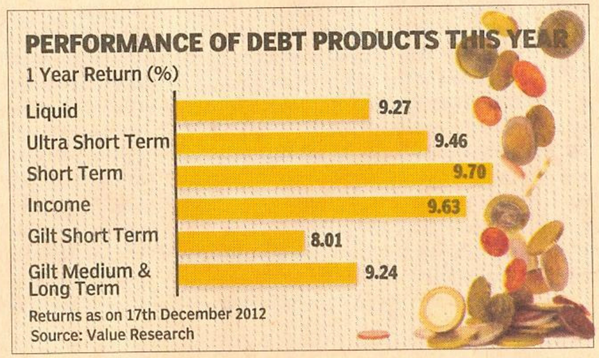
Mumbai, Dec 18: The Reserve Bank of India's (RBI) monetary easing steps beginning next quarter may make medium- and long-term income funds as well as dynamic bond funds more attractive for investment. But it will make fixed maturity plans and even liquid-plus funds less popular among rich investors to an extent.

The RBI, in its mid-quarter review of monetary policy on Tuesday, kept the repo rate unchanged at 8%, a move that was anticipated by a wide section of analysts. However, contrary to expectations, the central bank chose not to go ahead with the anticipated 25-basis point reduction in the cash reserve ratio.

"Debt products with duration calls will start giving higher returns. These include dynamic bond funds, income funds and gilt funds with maturity of two-and-a-half years and above," said Killol Pandya, head - fixed income, Daiwa Asset Management. "All these products have a lock-in, and those who are comfortable locking in their money for at least six months or more should look at them," he said.

And while corporate interest in liquid funds will continue, retail and high net worth individuals could move to duration products, which are likely to fetch double-digit returns. "Liquid and liquid-plus funds enjoyed huge popularity this year, even among investors with a longer investment horizon. Now that the cycle is turning, these funds might see some marginal redemption pressure on the retail and HNI side," said Pandya. Liquid funds gave average returns of 9.27% in calendar year 2012.



Returns as on 17th December 2012
Source: Value Research

Dwijendra Srivastava, head– fixed income, Sundaram MF, believes that investment in duration products could involve a certain amount of risk as there could be some volatility in the near term. "Investors who don't mind taking a certain amount of risk can look to invest in duration products. However, conservative investors can still invest in FMPs with a duration of 1 year or more," said Srivastava.

At present, one-year CDs are fetching returns of 8.8% compared with the repo rate of 8%, which means those invested into one-year FMP enjoy a spread of 80 bps. Assuming a fall in repo rate by 25 bps in January, a conservative investor who wants fixed returns can get a spread of 105 bps on a 1-year FMP if he invests today, says Srivastava. FMP new fund offers have declined drastically from 483 in the January-June period to just 107 in the July-November period.

Dynamic bond funds could be well-suited to ride the volatility in the interest rate curve next year, said market participants. This is because with these type of funds, the fund manager has the flexibility to move into short-term instruments such as commercial paper and certificate of deposits (CDs), or long-term instruments, such as corporate bonds and gilt securities, depending on his outlook on interest rates.

On Tuesday, yields of 10-year government bonds hardened by about 1 bps to 8.15% following the policy announcement, according to market participants. The yield for money market instruments, on the other hand, hardened by about 5 bps because of the spike in daily borrowing.