Choose the Tenure Wisely while Investing in Bonds

Should investors stay with long-term bonds or go for risk-free ultra short-term papers? Nikhil Walavalkar has some suggestions

Investment experts are divided about the fixed income strategy. Some argue that duration-based investing (that is, investing in long-term income funds and gilt funds) will work better in the coming days as these funds, which buy long-term bonds, will benefit from a fall in interest rates and will earn capital appreciation along with the coupon payable.

The other group dismisses the theory by highlighting the interest rate risk associated with these funds – if interest rates move up, these funds may see capital losses. They recommend the accrual-based strategy of investing in fixed maturity plans, ultra short-term bond funds and short-term bond funds. These schemes generally buy short-term instruments and prefer to hold them till maturity, which eliminates the interest rate risk.

As you can see both these strategies– accrual and duration – have merits, and it would be wise to consider the risk and reward they bring to the table. And also, you have to clearly define your goals and investing personality.

"Short-term interest rates — one-year to three-year — are attractive now. You should invest at least half of your portfolio in fixed maturity plans and short-term bond funds. If you can digest volatility, you can invest the rest of your money in duration-based products such as long-term income and gilt funds — since they are expected to do well as rates go down," says Vinod Jain, principal advisor at Jain Investment Planner.

CAN YOU STOMACH VOLATILITY?

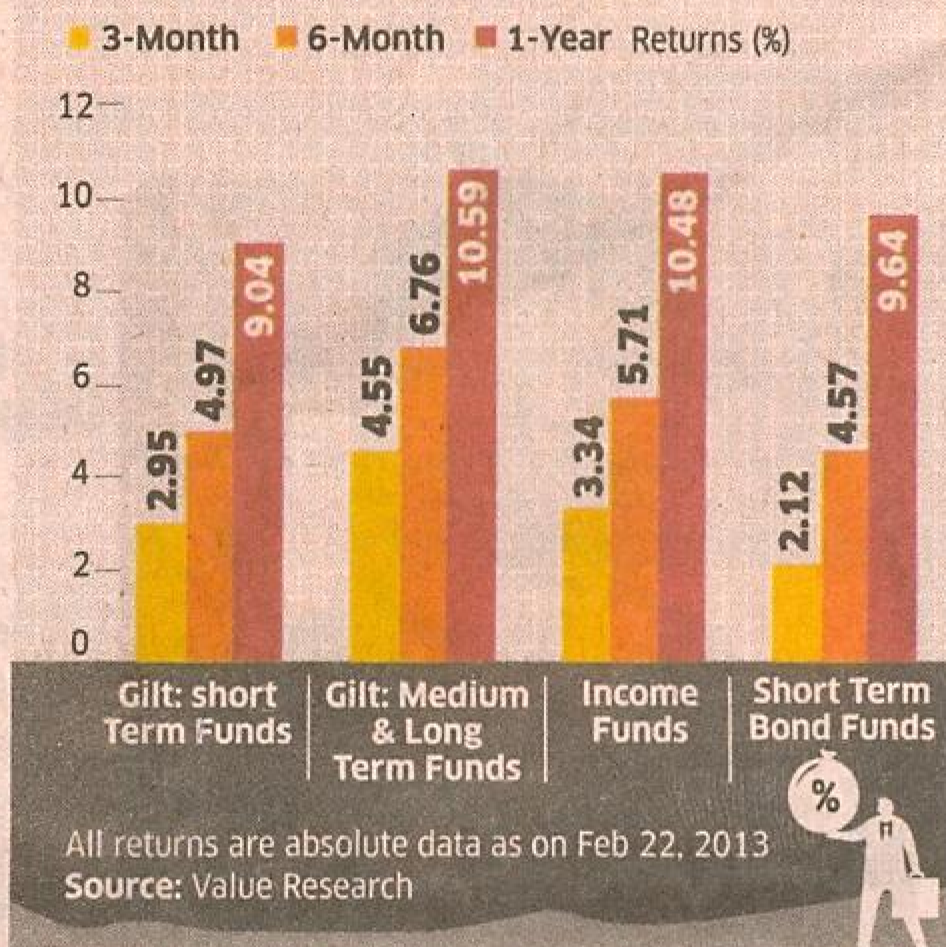
"How comfortable are you with volatility?" asks Dwijendra Srivastava, head of fixed income at Sundaram Mutual Fund. If you are not comfortable with volatility, you should stay away from duration-based products. In that case, you should invest in accrual-based products as long-term gilt and income funds will have intermittent volatility, he adds. If your aim is to earn steady income every quarter, your focus should be accrual-driven schemes. But if you are a short-term trader looking for higher returns with a penchant for risk, you can consider investing in duration products.

A bond investor gets two types of income – the rate of interest (technically known as coupon) and capital appreciation if there is a fall in interest rates. For the beginners, an accrual driven scheme is one that invests to earn interest that accrues at regular interval — say semi-annually. Typically such schemes — short-term bond funds — hold short-term bonds with maturities of one to three years. For the year ended February 22, short-term bond funds as a category has offered 9.64% returns, according to Value Research, a mutual fund tracking entity. A point to note: most of the five-star rated short-term bonds have portfolios with average maturity ranging between 1.3 and 2.3 years.

"Short-term bond funds do have some long-term bonds and they do earn some capital appreciation when rates fall, but the focus remains on earning interest," says Vinod Jain. But that is a small component of the overall returns one can get. Those keen to eliminate interest rate risks all together, consider investing in fixed maturity plans of one- and three-years.

The other extreme is the duration based products. Here the fund managers prefer to hold long-term bonds in a falling interest rate environment, such as the one we are in. When interest rates fall, the prices of long- term bonds go up. Longer the time to maturity, higher the capital appreciation is the norm.

In a falling interest rate scenario, such funds bring home dual benefit — the coupon payable on the bonds and capital appreciation. As the 10-year bond yield fell from 8.2% to 7.8% in last one year, medium & long term gilt funds and income funds offered 10.59% and 10.48% returns.



All returns are absolute data as on Feb 22, 2013
Source: Value Research

LOOK AT THE BIG PICTURE

Purely from the returns perspective, in the last one year duration strategy has surely done better than the accrual strategy. But one should not get swayed by such short-term numbers. "In duration products, your entry point is important and so does the interest rate cycle," says Devendra Nevgi, founder & partner, Delta Global Partners. The best point of entry is when the interest rate peaks. In the Indian context, if the 10- year benchmark quotes above 8.75%, it is considered to be a good entry point; as rates come down, investors entering at 8.75% and above benefit. But it may not be easy money.

Interest rates need not necessarily come down in straight line and there is the risk of fund manager, too. If the rates climb up due to adverse macro economic data, the net asset value of a fund holding long-term bonds may fall, as the marked-to-market prices of the bonds fall, too.

If you don't want to compromise on liquidity, invest in short-term bond funds. But if you are keen to take some risk, go for long-term bond funds

Fund managers can also change the portfolio composition depending on their views on interest rates. If they expect rates to fall, they may hold more long-term bonds and the other way round. If the fund manager's call goes wrong and the rates go up, his portfolio will see losses. There are instances where the fund manager may book losses. Put simply, there are incremental risks you are taking for incremental returns.

If you are not keen to take risk, do not lose heart. You are not missing much. "In general, more than 75% of the returns from government bonds in the very long run have come from the coupon and reinvestment of the same. And the rest comes from capital gains," says Devendra Nevgi.

"If you want to build an accrual portfolio, the recent spike in short-term rates offer a good opportunity," says Dwijendra Srivastava. Fixed maturity plans can be good vehicles at this moment. "If you don't want to compromise on liquidity, you should invest in short-term bond funds," says Vinod Jain. But if you are keen to take some risk, go for long-term bond funds such as SBI Dynamic Bond, Kotak Bond Fund, Canara Robeco Income Fund, with a two-year time-frame, he adds.

"We are expecting 50 basis point cut in key policy rates this calendar year," says Dwijendra Srivastava. This should help the long-term duration products. Depending on your risk profile and time frame, you can create a mix of accrual and duration products in your fixed income portfolio.