Debt Mutual Funds help achieve your financial goals.

To achieve goals in life, one needs to understand investments thoroughly. Debt Mutual Fund is an option for long-term and short-term financial goals depending upon the type of funds you choose. Now, lack of awareness shouldn't be a barrier for achieving your goals.

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BEGINNER'S GUIDE TO DEBT MUTUAL FUNDS

WHAT ARE DEBT MUTUAL FUNDS?

Debt mutual funds are the funds that invest in "debt instruments", which include treasury bills, government securities, Certificate of Deposits (CDs), Commercial Papers (CPs), bonds, money market instruments and many more. These are called debt instruments because the issuers have borrowed money from the lender (investors) by issuing these instruments. These "debts", are income generating instruments. This income could be monthly, semi-annually, annually or at maturity. However, most debt instruments are unavailable directly to the retail investors. But, they can invest in those debt instruments indirectly through Debt Mutual Funds. For retail investors, Debt Mutual Funds are the best way to invest in debt i.e. income generating instruments.

Debt Mutual Funds normally provide capital appreciation when interest rates are falling. They generally protect your portfolio in an economic downturn when other avenues for investment are not performing well.

The returns of a debt mutual fund comprises of -

- Interest income
- Capital appreciation/depreciation in the value of the instruments due to changes in market dynamics

The above facts will make you aware that investing in debt mutual funds requires some basic understanding of how they work and what are the factors they are affected by. As part of an investor education and awareness initiative by HDFC Mutual Fund, we have tried to capture our expertise and experience for your benefit. This will enable you to understand about investing in debt mutual funds.

TYPES OF DEBT MUTUAL FUNDS:

There are different types of Debt Mutual Funds that primarily invest in various fixed income securities across different time horizons.

Some basic types of debt funds offered by mutual funds are as under:

Income Funds:

An income fund is a type of mutual fund that primarily invests in debt instruments with various maturity or duration and money market instruments.

Short Term Funds:

A short-term or short tenure debt fund is a fund that primarily invests in debt instruments with shorter maturity or duration.

Floating Rate Funds:

The objective of Floating Rate Funds (FRFs) is to offer steady returns to investors in line with the prevailing market interest rates. While income funds invest in fixed income debt instruments like bonds, debentures, government securities etc., FRFs are a variant of income funds with the primary aim to minimise the volatility of investment returns that is usually associated with an income fund.

Liquid Funds:

As the name suggests, liquid funds invest pre-dominantly in highly liquid money market instruments and provide liquidity.

Gilt Funds:

The word 'Gilt' implies government securities. A gilt fund invests in government securities of various tenures issued by central and state governments. These funds generally do not have the risk of default since the issuer of the instruments is the government.

Fixed Maturity Plans (FMPs):

Fixed Maturity Plans (FMPs) are close-ended debt funds offered by mutual funds investing in debt instruments with a specific date of maturity that is less than or equal to the maturity date of the scheme.

Units of close ended funds can be purchased from the Mutual Fund only during the New Fund Offer and cannot be redeemed during the tenure of such funds. The Units of these funds are available for trading on stock exchanges for the purpose of providing liquidity to the investors.

Interval Funds:

Interval Funds are the funds investing in Debt/Money Market Instruments and Government Securities having residual maturity until the beginning of Specified Transaction Periods (STPs). Interval funds have characteristics of both open and close-ended funds. In other words, these funds are open for subscription and redemption during the STPs. Thereafter, units of these funds are available for trading on stock exchanges.

Monthly Income Plans:

Monthly Income Plans are debt oriented hybrid funds with the objective of generating regular income through investing in primarily debt and money market instruments and the secondary objective of generating long-term capital appreciation by investing a part of the scheme's funds in equities.

Multiple Yield Funds:

Multiple Yield Funds are hybrid debt oriented funds which invest predominantly in debt instruments and balance in dividend yielding equities. The debt instruments assist in generating returns with minimum risk and equities assist in capital appreciation.

Capital Protection Funds:

Capital Protection Funds (CPFs) are close-ended schemes. The allocation to debt instruments is done in such a way that at the end of the term of CPFs, the value of debt investment is equal to the original investment in the fund. The equity portion aims to add to the returns of CPFs at maturity. These funds are oriented towards protection of capital and do not offer guaranteed returns. Investments only in highest rated debt instruments are permitted.

As per SEBI (Mutual Funds) Regulations, CPFs need to be rated by a registered credit rating agency such as CRISIL, ICRA and others. The investor can assess the safety of his capital from the rating assigned to these funds. The rating assigned to CPFs is reviewed on a quarterly basis by the concerned rating agency.

Dynamic Bond Funds:

Dynamic Bond Funds are debt funds that invest in debt securities of different maturity profiles. These funds are actively managed and the portfolio varies dynamically according to the interest rate view of fund managers. This fund gives the fund manager the flexibility to invest in short or longer term instruments based on his view on the interest rate movement.

BENEFITS OF INVESTING IN DEBT MUTUAL FUNDS:

Portfolio Diversification:

Investment in debt mutual funds acts a portfolio diversifier. Owning a certain portion of assets in debt mutual funds shields your capital from the volatility of the equity markets and at the same time helps you generate regular income.

Risk Exposure:

There is lesser exposure to risk of capital loss as compared to equity investing. Under normal circumstances, investments in debt mutual funds are less volatile as compared to equity mutual funds. However, debt funds are exposed to interest rate risks and credit risks.

Minimum investment amount:

Debt mutual funds provide exposure to a diversified portfolio of fixed income instruments like Bonds, Non Convertible Debentures (NCDs), Government Securities (G-Secs), Corporate Debt instruments, Certificate of Deposits (CDs), Commercial Papers (CPs) etc. Retail investors are not able to invest in these instruments on account of higher minimum investment amount. Retail investors can take the benefit of investment in these instruments through debt mutual funds by making a minimum investment as low as ₹ 5,000.

Generation of regular income:

Debt mutual funds help in generating regular income as they take exposure to instruments that pay regular interest income to the portfolio. These Funds primarily target current income instead of capital appreciation. Hence they distribute a substantial part of their distributable surplus to the investor by way of dividend distribution. The dividends could be distributed daily, weekly, fortnightly, monthly, semi-annually, annually or at maturity, depending on the type of debt mutual fund.

Generate income in line with interest rates:

Debt mutual funds seek to generate income in line with the prevailing interest rates. However, one needs to select the right type of fund matching ones investment time horizon as well as the one which suites the best in the prevailing interest rate scenario.

Avenue to park short-term funds:

Unlike equity mutual funds which are very volatile in the short-term, there are categories of debt mutual funds such as liquid funds which provide an investment avenue to park the funds for a short-term period.

HOW TO EVALUATE DEBT MUTUAL FUNDS?

The criteria for evaluating a debt mutual fund are as under:

Portfolio Allocation:

The portfolio of a Debt mutual fund shows (a) instruments in which the scheme invests (b) composition/weightage of each instrument in the portfolio and (c) the risk profile depending on the credit rating of the issuer.

Investment horizon:

Generally, every debt mutual fund specifies an ideal investment horizon for which the product is suitable. The same should be kept in mind to earn optimum returns.

Credit rating:

The credit quality of debt mutual fund is determined by quality of debt instruments that the fund invests in. The credit ratings are given by agencies like ICRA, CRISIL, CARE etc. which is evaluated based on extensive research on the creditworthiness of the issuer. A higher credit rating primarily indicates lower issuer default risk and vice-versa. Higher investment in Government Securities implies less risk. This information is easily available from the factsheet which is issued by mutual funds on a monthly basis and the scheme portfolios are also uploaded on the website of respective mutual funds on a monthly basis.

Average Maturity and Modified Duration:

A bond portfolio usually consists of a number of bonds where each could have a different maturity date. Maturity is the time period remaining before which a bond comes up for repayment by the issuer. Average maturity is simply the weighted average time left up to the maturity of the various bonds in a portfolio.

	Maturity	Invested amount (₹)	Maturity x Invested amount (₹)
Bond 1	1 year	300000	300000
Bond 2	2 years	100000	200000
Bond 3	3 years	500000	1500000
	Total	**900000**	**2000000**
		Weighted average maturity =	2000000/900000= 2.22 years

In the above example, there are 3 bonds in a portfolio with a maturity of one, two and three years and Rupees one lakh, three lakh and five lakh invested in them respectively. The weighted average maturity of this portfolio is 2.22 years.

Duration of a bond indicates the time that the coupon cash flows of the bond (i.e. the interest cash flow received on the bond) will take to equal the price paid. This is also called as Macaulay duration and is usually used to measure the sensitivity of a bond to interest rate variation as the bond price is inversely related to its yield. Modified duration is a variant of Macaulay duration and is used to measure how much the bond price will vary for every 1% change in yield. If say, the modified duration of a bond or portfolio is 3, then 1% change in yield will cause a 3% change in bond price.

Yield to Maturity:

Yield to Maturity (YTM) is indicative of what returns can be expected out of fund's portfolio. YTM must be compared with current returns of your traditional safer instruments. YTM of debt funds should not be abnormally higher as these would at times mean compromising on the quality and safety of instruments. This increases credit risk in those instruments held by the debt funds and at times even leads to liquidity risk also.

- **Difference between YTM and Total Returns:**

Coupon is the interest rate that a bond pays and is usually mentioned as a percentage of the face value of the bond. Yield is nothing but the coupon rate expressed as a percentage of the purchase price of the bond. Yield To Maturity (YTM), therefore is what the bond will earn from its coupon alone with respect to its purchase price, if held till its maturity. That is, the assumption is that the bond is redeemed at the face value on maturity.

YTM is calculated on interest rate divided by market price of security.

Face Value of a bond	₹ 100
Coupon (p.a.)	8%
Purchase price of bond	₹ 105
Current yield of bond (₹8/₹105)	7.62 %
Years to maturity	3
Coupon receipt year 1	₹ 8
Coupon receipt year 2	₹ 8
Coupon receipt year 3 along with principal on maturity (face value)	₹ 108
YTM (IRR of above 3 cash flows)	6.13%

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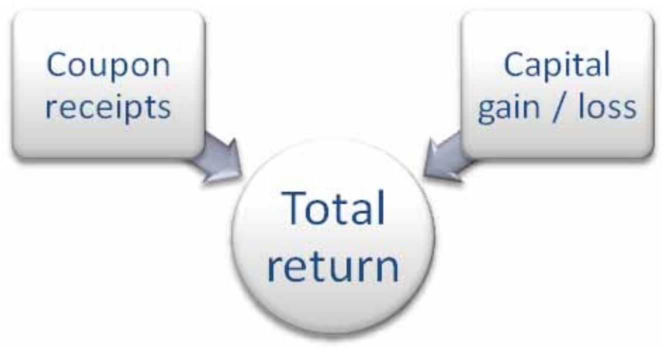
For the scheme, total return is the sum of the coupon payments and capital gains if any, on the bond price. Bond price variation may cause capital gain or loss. Gain will be added to coupon income and loss subtracted from coupon receipts to obtain total return.



The information on Average Maturity, Modified Duration and Yield To Maturity is usually available in the factsheet issued by the mutual funds.

HOW TO CHOOSE DEBT MUTUAL FUNDS?

The following needs to be considered for choosing a debt mutual fund:

Determine the investment goal:

It is very important to choose a fund that suits one's needs. Debt funds may aim for various investment goals like capital appreciation, capital protection, regular income, etc. Perhaps, one would simply look for a way to diversify a portfolio by investing in debt funds. Ultimately, the debt fund one chooses will be determined by his/her investment goals.

Determine the time horizon and fund maturity:

Secondly, one needs to ascertain the time period for which they would want to stay invested. This is because the maturity profile for each fund category is different. Ideally, one should match the time horizon of the fund with their liquidity requirement.

Assess Your Risk Tolerance:

Once the investment goals and time horizon is determined, one needs to assess how much risk he/she is willing to take to achieve a higher return. A conservative investor would typically favour lower-risk debt mutual funds. Conversely, an aggressive investor would typically favour a medium to higher-risk debt mutual funds.

Portfolio Credit quality:

This is necessary to determine the risk of default by the issuer. The higher the credit rating assigned to the portfolio of debt mutual funds, the safer the investments are considered. Debt mutual funds invest in several instruments, ranging from risk-free government securities to high-risk corporate paper.

Understand the Market Environment:

The value of debt funds depends on the prevalent interest rates. If the rates rise, debt funds lose value, and vice-versa. This is because of the inverse relationship between interest rates and bond prices.

Expense Ratio & Exit Loads:

The expense ratio is the annual expenses incurred by the funds expressed in percentage of their average net assets. Unlike an equity fund, the expense ratio is critical for a debt fund as the returns are comparatively low. To make choice between debt mutual funds, one should also consider the expenses charged by them. The mutual funds are required to disclose the current expense ratio on their websites. Most debt mutual funds are subject to exit loads. Therefore, at the time of choosing debt mutual funds, one should consider chargeable exit load keeping in view your investment horizon.

- **Impact of exit load on returns:**

Exit load is a sort of penalty imposed by mutual funds to encourage investment by investors in line with the investment horizon and objective of the scheme and to discourage premature redemptions by investors, which would be disadvantageous to other investors.

Exit load is deducted from the redemption price, making it lesser than the NAV. Exit load would reduce the investment returns. For e.g. If a scheme has an exit load of 1% for redemption within a year and the return for a year was 10%, if the investment is redeemed at 1 year, the actual return for the investor would be 9%. Thus, frequent churn of portfolio will affect the returns earned.

For further information, contact your financial advisor or call us at 1 800 3010 6767.
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