How fixed income can help create an ideal portfolio during times of volatility

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Investing

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Synopsis

Mutual funds are one of the most liquid investment vehicles. However, investors also need to generate steady income, usually provided by the fixed-income allocation. It ensures safety of capital, inflation-beating returns, a regular income, and liquidity during uncertain times.

India has been a great country to invest in. Investors have reaped handsome returns from exposure to the equity markets through mutual funds. Most investors, both institutional and individuals, put safety of their corpus first. Then comes the need for

generating returns on the portfolio, which should at least beat inflation.

Inflation increases the prices of goods and services and unless the investor can generate a return at least equal to the inflation rate, his/her real purchasing power goes down. Investors also need transactional as well as periodical liquidity in the portfolio.

Liquidity is defined as the ability to convert an asset into cash, without a significant loss of value from the fair price. Mutual funds are one of the most liquid investment vehicles. Investors may also need to generate steady income from the portfolio, which is typically provided by the fixed-income allocation.

Hence, an investor typically requires safety of capital, returns that beat inflation, a regular income and liquidity, which implies low volatility.

Capital safety and returns
Over the past 15 years, Nifty has generated ~14.5% annualised returns, which is a remarkable inflation-beating performance. The equity ride has been a roller coaster though, with markets falling 51% in 2008 and recovering 75% in 2009. While the exposure to equities has given returns over a long-term horizon, one could get badly impacted by the interim volatility.

In the past 15 years, the S&P India Bond Index, a fixed-income index, has generated a return of 8.63% annualised. While the returns are lower than those of equities, they have beaten inflation quite smartly. The volatility profile is drastically different from that of equities. While in case of equities, the range was from -51% to +75%; for bonds annual returns were between -0.15% and +18.7%.

Given the variety of needs that an investor has in terms of safety, returns, income and liquidity, most portfolios allocate a higher weightage to fixed income compared to equities. Given the higher volatility of equity, and the need for liquidity, the equity weightage of an average would be around 20%-30%. At times, investors do not realise that a large amount of their fixed-income exposure could be through bank deposits, insurance policies, provident funds etc. While enough time is spent on researching equities, not enough attention is given to fixed-income instruments.

Picking the right debt fund
Mutual funds provide an array of fixed-income products that can meet the requirement of safety, income, and liquidity. Debt funds are classified mostly as per their maturity profile. Liquid funds invest in papers that mature within 90 days.

One risk in fixed-income securities is that of interest rates. The bond prices fall if interest rates rise. The greater the maturity of a bond, the greater the fall in price, for a given increase in interest rates. As the maturity in liquid funds is lower than 90 days, the interest rate risk is quite low, and most investors use this fund for parking surplus cash for a few days.

Similarly, there are ultrashort, low duration and money market funds, which keep the maturity below a year and hence carry a low-interest rate risk.

Mutual funds can invest in government securities, which have maturity range from one year to 40 years. They also invest in corporate bonds (1-15 years of maturity), which typically have higher yields than government bonds of similar maturity. With different combinations of government securities and corporate bonds, fund managers craft different funds as per the maturity profile.

Then there is the short-term fund with a maturity around one-three years. Over the years, a few variants of short-term funds have come into being like the credit fund, banking and PSU debt fund and corporate bond fund. Short-term funds are an evergreen category, which generates reasonable returns if held over a considerable period. However, credit funds have fallen out of favour with investors.

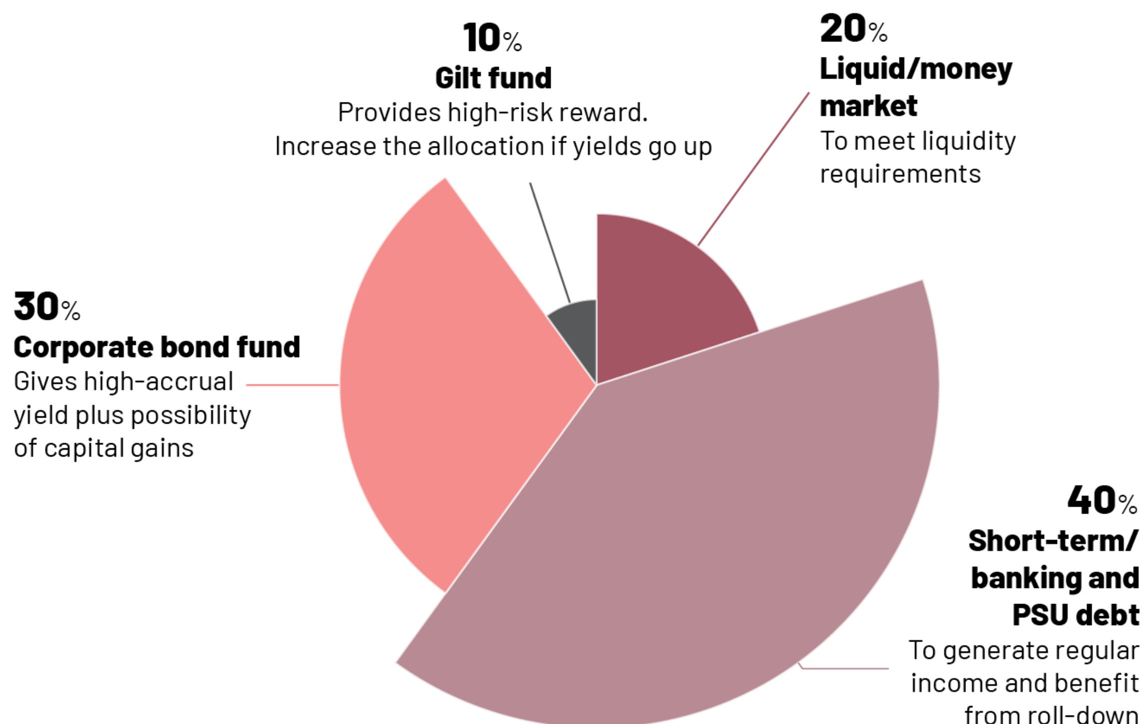
Corporate debt funds are another popular category, which could do well in the coming quarters.

The bottom line

Interest rates in India have risen by almost 150 bps - 200 bps in the last few quarters. The global central banks were printing money in a bid to restore economic activity after the pandemic-induced slowdown. As a result of excess money, prices of cryptocurrencies and commodities rose sharply, wages soared, and inflation shot up, much above the comfort zone of the regulators.

Central banks hiked rates and tightened liquidity. This led to a rise in market yields, leading to a fall in bond prices. It is possible that, going forward, corporate bond funds could provide a good risk-return trade off to investors as portfolio yields have already risen quite a lot and a possibility of further fall in prices appears low.

Under, the current scenario, where rates are expected to remain elevated and come down over a period of time, an ideal debt portfolio as depicted below:



This calendar year, the Nifty has returned 4.9% at the time of writing this article. Given the high valuations and headwinds in the form of tight liquidity and rising rates, equities could witness another subdued year. Time to concentrate on debt portfolio, which is anyway the lion's share of an investor portfolio.

(*The author is CEO, TRUST Mutual Fund. Views expressed are personal*.)