Selecting debt fund? Six factors to consider

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The steep fall in FD rates may soon motivate low-risk investors and those looking to park their short-term surpluses to look towards alternative avenues such as debt mutual funds.

The first step towards selecting the right debt fund is to find out your risk appetite and time horizon of your financial goals. (Illustration: SHYAM Kumar Prasad)

Bank fixed deposit rates registered a steady decline in response to the 135 bps repo rate cut since the February 2019 RBI policy meeting. For some private sector banks, reduction in their FD card rates of one-year tenure have been as steep as 75 bps over the same period.

The steep fall in FD rates may soon motivate low-risk investors and those looking to park their short-term surpluses to look towards alternative avenues such as debt mutual funds. After all, falling interest rates lead debt fund returns to register higher returns. However, with over 16 debt fund categories and over 300 debt funds to choose from, wrong fund selection can risk sub-optimal returns or worse, capital erosion.

Here, are the major factors to consider while selecting debt funds.

Optimum debt fund category

The first step towards selecting the right debt fund is to find out your risk appetite and time horizon of your financial goals. For example, credit risk funds have to invest at least 65% of their corpus in corporate bonds below the highest rated instruments whereas corporate bond funds invest at least 80% of their assets in corporate bonds having the highest rating. Once you get the appropriate fund category for your time horizon and risk appetite, consider the following quantitative indicators in various debt fund portfolios of the selected fund category.

Average maturity and modified duration

Average maturity refers to the weighted average of maturities of various instruments held in a debt fund's portfolio. Modified duration of a debt fund is the sensitivity of its portfolio to changes in the interest rate. Debt funds with higher average maturity and modified duration are more sensitive to changes in interest rates. Hence, funds with higher average maturity and modified duration do well during falling interest rate regime whereas those with lower modified duration and average maturity perform better during rising interest rate regime.

Expense ratio

Expense ratio of a fund is the proportion of its total assets used for meeting it total expenses. Expense ratio is a major factor while choosing debt funds, especially those belong to the liquid, ultra-short and low duration categories, as they have limited upside potential compared to equity funds. Hence, opt for direct plans of debt funds as these have lower expense ratio than the regular plans.

Yield to maturity (YTM)

This refers to the weighted average yield of the portfolio constituents of a debt fund. It gives a fair idea about the interest income that can be accrued if all its portfolio constituents are held till maturity. Funds investing in fixed income instruments with higher coupon rate have higher YTM than others. However, YTM cannot be the sole indicator of the potential gains from debt funds as their actual returns would also depend on changes in their portfolio and mark-to-market valuations. During fund selection, consider the net YTM of the fund portfolios, which refers to Gross YTM minus the expense ratio.

Portfolio constituents

Debt funds list the credit ratings of underlying portfolio constituents in the fact sheet. These ratings indicate creditworthiness of the issuers of those securities. For example, instruments with credit rating of AAA have the lowest credit risk while those having C are considered to have high default risk. A quick review of the fund factsheets will give you a fair idea about the credit risk exposure of debt fund and its compatibility with your risk appetite. As instruments with lower credit ratings have the potential to generate higher returns, a review of the fund's portfolio constituents would also help you gauge the fund's upside potential.

Current interest rate regime

The market price of existing fixed income securities rises during falling interest rate regime as their coupon rates are most likely to be higher than those offered by freshly issued debt securities. Whereas in case of rising interest rate regime, the price of existing fixed income securities fall as investors prefer to invest in newly issued securities offering higher coupon rates than the older ones. As a result, debt funds witness higher capital appreciation during falling interest rate regime and vice versa.

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