FINANCIAL EXPRESS
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Debt Mutual Funds: Is higher Yield to Maturity = Higher Returns?

Published: July 9, 2019 3:17:49 PM

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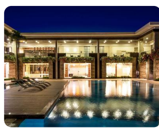
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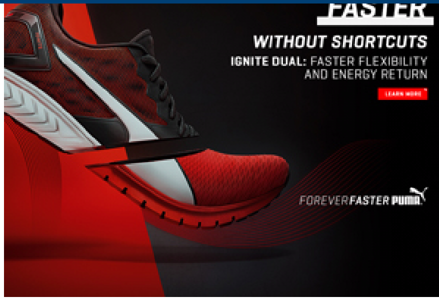
Owing to negative returns or loss of capital in a few scenarios, investors are becoming increasingly cognizant about the inherent credit risks.

Debt mutual fund schemes have historically helped investors earn higher returns while providing liquidity and tax efficiency, specifically in comparison to fixed deposits. Usually, when bank deposit rates are on a downward trajectory, most investors tend to scout for debt funds providing relatively higher returns. As on 27th June 2019, Median one year returns of liquid and ultra-short duration categories are 7.4% and 7.8%, respectively. With increased penetration of mutual funds, assets under management of debt schemes have doubled from around Rs 6 lakh crore in March 2014 to Rs 12+ lakh crore as on May 2019. Retail investors have cumulative exposure of 3.4 lakh crore for debt-oriented mutual funds and 87k crore in liquid/money market instruments.

While investing in debt funds, it has been observed that investors typically chase high returns by selecting funds which have high Yield to Maturity (YTM). Usually, they ignore many other aspects/features and may underestimate the inherent risks associated with the debt funds.

Before understanding risk, let us first understand how debt funds generate returns for investors. Debt funds generate returns for investors by investing their corpus in various securities such as non-convertible debentures, certificates of deposits, commercial papers and money market instruments, G-securities among others. Debt funds earn interest on these underlying securities and at



the course of holding period and hence benefitting from mark-to-market.

Since September 2018, few companies have either defaulted on their interest / principal payment or have been subjected to ratings downgrade by credit rating agencies. Both these scenarios have negatively impacted mutual fund schemes holding outstanding debt securities issued by these companies. Various companies which have come under the scanner include IL&FS, DHFL, Essel Group companies, Anil Dhirubhai Ambani Group companies and Yes bank. Most of the outstanding securities of these companies were rated AAA at the time of investment by Fund Manager.

Over the course of the last few months, these securities have become stressed assets either due to the overall industry in which they operate being stressed or due to mismanagement. Post-default/ratings downgrade, mutual fund houses had to mark down these securities as per SEBI guidelines. For example: AMC schemes having DHFL exposure had to mandatorily mark down the value DHFL securities by 75%. Mark-down implies a reduction in the price of securities held. Such markdown in turn reduces NAV of the concerned schemes. Reduction in NAV leads to erosion of returns to investors.

Owing to negative returns/loss of capital in a few scenarios, investors are becoming increasingly cognizant about the inherent credit risks. Earlier, many investors especially retail investors used to derive their investment decision basis yield to maturity rather than risk-adjusted returns. In turbulent times such as the current scenario, the importance of ensuring the underlying portfolio of high credit quality is amplified.

To understand the impact of defaults of underlying securities on returns lets us analyses the following table:

Debt Categories	YTM as 31st May'18	1-year Return *
Liquid		
Principal Cash Management Fund	7.20%	-2.00%
Low Duration		
Baroda Treasury Adv Fund	8.30%	-12.50%
Edelweiss Low Duration Fund	8.00%	-5.40%
Principal Low Duration Fund	8.70%	-11.20%
Credit Risk		
BOI AXA Credit Risk Fund	11.60%	-48.80%
IDBI Credit Risk Fund(G)	9.30%	-1.00%
* As on 27th June		

Source: ACE MF, portfolio YTM as of 31st May, *2018 and returns data of 27th June, 2019*

Above table is a select representation of debt schemes across various debt categories. As evident, most of these debt schemes had high YTM as of May 2018. However, one year later as of May'2019, investors who would have invested in these schemes, have even experienced erosion of their principal investments. In nutshell, it is important to understand that shortlisting debt mutual fund basis higher YTM vis-à-vis peers may not necessarily be the right approach.

Therefore, it is extremely important for investors looking to invest in debt mutual funds to evaluate all aspects of the fund before taking investment decision and prioritize the safety of capital over chasing returns. Investors having an objective of wealth creation may be better off by investing in equity schemes rather than chasing debt mutual funds with higher YTM. Given the current scenario of uncertainty, investors should preferably identify schemes having a higher concentration of AAA-rated securities.

(By Devang Kakkad, Head of Research Equirus Wealth Management)

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