RBI repo rate cut: Gilt mutual fund returns better than FDs, but experts suggesting this better option

By: Sunil Dhawan | Updated: February 8, 2019 1:00 PM

Amongst the debt funds, over the last three years, the 'Long Duration funds' and 'Gilt funds' have generated an annualised return of about 9.03 per cent and 7.90 per cent respectively.

Gilt mutual fund returns looking attractive but here's why experts are suggesting to avoid them and instead invest in these debt fund schemes.

For the first time in nearly 16 months, the RBI has cut the repo rate. The last time it happened was in August 2017. Today the repo rate, the rate at which banks borrow money from the RBI, stands at 6.25 per cent, which in August 2017 was set at 6 per cent.

Does the recent rate cut signal a reversal in the interest rate cycle? Jason Monteiro, AVP – MF Research & Content, at Prabhudas Lilladher says, "Yes, after two rate hikes of 25 bps each in June and August last year, the rate cut brings a reversal in the trajectory of the policy rate. While the RBI has changed its stance to 'neutral', signalling interest rates can go either ways as markets are expecting another 25 bps cut considering the inflation trajectory."

However, inflationary pressure may still be out there and may dampen the benign interest rate scenario. "We do not see a deep rate cut cycle as the inflation trajectory is most likely to reverse from here. We also see multiple upside risks to the RBI's inflation projection of sub 4 percent which if materialises will reduce market expectations of any further rate cut," informs Pankaj Pathak, Fund Manager, Fixed Income, Quantum Mutual Fund.

It could be little early to say that more rate cuts may be in the offing as oil prices, US Fed and our own inflation numbers, especially food prices post elections, will help decide the medium-term outcome of interest rate cycle. "While the change

Debt funds are tax-efficient investments over 3 year period. Amongst the debt funds, over the last three years, the 'Long Duration funds' and 'Gilt funds' have generated an annualised return of about 9.03 per cent and 7.90 per cent respectively.

What's now for debt MF investor

At the time when the interest rates were looking to go up, most industry experts recommended debt MF investors to stay put in short-term debt mutual fund schemes. Here's why: When rates tend to go up, prices of existing bonds fall and so do the NAV of the MF schemes. The fall is more pronounced in case of debt funds holding bonds with longer maturities compared to those funds holding bonds with shorter maturities. So, going by that reasoning, when rates tend to fall, should the reverse be the approach and should one consider longer dated securities or the Gilt (government securities) funds?

Going by what experts tell us, Gilt funds may still be avoided. "Even though long duration bonds and Gilts look attractive based on the current monetary stance, retail investors should avoid taking an exposure if they do not plan to actively manage their portfolio," says Monteiro.

Is the time right for Gilt funds

If the rates do not move as expected, Gilt fund investors may be in for a rude shock. Monteiro explains it with a real example: The 10-year G-sec yield was near 8 percent in September 2018, and moved lower by nearly 70 bps to 7.30 per cent by December end. The market was expecting a dovish stance from the RBI. Hence yields eased over the period. In the December quarter itself, long-duration funds and Gilt funds (10yr) generated an absolute return of 6 percent. An investor who enters now would be a bit too late to capitalise on the rally that began a few months ago. So it's best to avoid playing the duration strategy. It can also be highly risky if interest rates movements do not pan out as expected.

Entering Gilt funds in these time may have its own share of risk and volatility in returns. "Given the large government borrowing of Rs 36,000 crores extra in this financial year and approximately Rs 7,10,000 crores in the next financial year, it may lead to steepening of yield curve and also volatility of returns at the long end of the curve. Hence, we would not be recommending the same at this point in time," says Kakkad.

What should debt fund investors do now

Debt fund investors may stick with ultra-short term, short term or low duration funds. "Given the high uncertainties investors should avoid much exposure to interest rate risk and should stick to debt funds with low maturity profile," says Pathak. Still, as an investor if one wishes to generate returns out of the interest rate uncertainty and volatility, there are dynamic bond funds to opt for. "A better alternative is to let the an experienced fund manager do this for you by investing in a Dynamic Bond Fund," says Monteiro.

Among the debt MF schemes, the credit opportunities funds or other funds that carry credit risk, may safely be avoided by conservative debt fund investors. A word of caution from Pathak – "The credit crisis that begun in the Indian bond markets after the IL&FS default in September is not over yet and debt fund investors should continue to choose safety over credit and liquidity over returns while investing in bond funds."