Debt Funds Crisis: Future Ahead

Manish Yadav, Manager (Research), SBICRM – published in Indian Banker in Dec, 2019

What are debt funds?

Any business entity can raise funds for its business purpose through two major means: 1) Equity and 2) Debt. The equity issuance is like selling the stake in the business. It is costlier and the investor in equity retains the upside in the business, in case the business makes profit; but has to also face the risk of losing money in case, the business makes losses. However a debt investment, is actually giving a loan to the business entity. The buyer of debt will get the principal and the interest on agreed terms, on regular basis. It is irrespective of the fact, whether the business makes a profit or books a loss. The equity instruments give more returns however the return volatility is high. In the case of the debt, the buyer of the debt instrument is assured of steady and predictable returns. The interest paid on debt is tax deductible and counted as a business expense. Compared to the equity, the debt is cheaper for the business entity. Investors invest in equity to get more returns, at the cost of more risk. However to complement a risky stock portfolio and to get a steady stream of income debt is purchased. Stocks are good inflation hedge; however the debt instruments are poor inflation hedge. As the payment of the principal and the interest are constant, and their value decreases in real terms with increasing inflation.

A debt fund invests in debt instruments, which generate a steady source of income. Some examples of debt instruments are: Corporate bonds, Government securities, Treasury bills, Commercial papers, certificate of deposits etc.

Types of debt funds

Debt funds can be broadly classified in to following categories:

1) Liquid funds- Invest money in securities with residual maturity up to 91 days. They can be used to park surplus money for higher returns in shorts term. They generally do not have a lock in period.
2) Short term bond funds- Here money is invested for a time period less than 5 years. Typical instruments for this type of funds are commercial paper and certificate of deposits.
3) Long term funds- These funds invest money for more than 5 years. These funds provide best returns when the yield curve is downward sloping.
4) Credit risk funds- These funds invest money in lower rated issues and hope that their rating will improve giving them a capital appreciation.

Risks involved

Superficially it seems, that the debt instruments are risk free, however this is not the case and there are some risks involved with debt instruments also. Some of the major risks in these instruments/funds are:

1) Interest risk- This is also known as price risk. Whenever there is a change is the interest rates the price of a debt instrument also changes. Let us see how. Actually the current market price

of a debt instrument is discounted value of cash flows that it will generate for the buyer of the instrument. This discounting is done at an interest rate where we have included appropriate spread for various risks. If the interest rate increases, the future value of these cash flows will decrease and vice versa. So whenever there is a change in interest rate, the value / price of a debt instrument changes. It is benign for an investor that the interest rates decreases, as it will lead to increase in the value of his holdings. However there is always a chance of increase in interest rates and therefore corresponding decrease in investor's debt portfolio. This risk is known as interest rate risk. As of now the interest rates are going southwards and the value of debt instruments is increasing.

2) Credit risk- This risk arises from two factors- a) Inability of the debt issuer to repay the debt, either partially or fully. This is also called default risk. A business entity may become insolvent and may not be in a position to honor its commitments. For example in the case of IL&FS the firm was unable to repay its obligations towards its debt investors. b) Decline in creditworthiness of an instrument. Credit rating agencies like Crisil, Care etc regularly rate the debt instruments of business entities. These ratings may move downwards, from a better rating, to a lesser one. This leads to decrease in the price of the debt instrument of the entity. This is also a type of credit risk. For example the debt instruments of DHFL have been downgraded sometime back.
3) Reinvestment risk- The principal and the interest received by the buyer of the debt has to be reinvested by him. If the buyer of the debt fails to reinvest these cash flows at favorable interest rates, the final return of the buyer of the debt will be lesser. Because the interest rates keep on changing and may move southwards, at the time of the reinvestment. The final return of the investor may be less than, what was anticipated. The moot point here is that increase in interest rates will increase the interest rate risk (as mentioned in point number 1), while it will decrease the reinvestment risk and vice versa.
4) Call risk- There is a chance that the issuer of the debt instruments i.e. the business entity or the Government, may repay the loan taken as debt (if there is a call option in the covenants), to the buyer of the debt before its maturity. This generally happens at the time when the interest rates are down and the business entity may get the debt refinanced at a lower rate. However for the investor, this would have been the time when the value of his portfolio would have increased. Hence there is a loss for investor. Moreover the investor has to reinvest the repaid loan, at lower interest rates now. The act of repaying the loan in advance is called Calling up the loan and it leads to call risk.
5) Foreign currency risk- Sometimes the loans are taken in foreign currency. In such cases, the movement in currency prices will also lend risk, to the investor's portfolio. If the currency in which the loan is repaid, depreciates, the cash flows from loan will decrease in value (in local currency post conversion). Hence there is a currency risk in cross border loans.
6) Inflation risk- We had already given inkling, that the debt instruments are poor inflation hedges. This stems from the fact that the cash flows received by the investors from debt instruments are generally fixed in amount. In case of increasing inflation scenario, the real value of these cash flows will decrease. Hence there is an inflation risk also in debt instruments.

Current Crisis in Debt funds

Currently the debt funds market is undergoing a deep crisis which was followed by default by IL&FS, DHFL, ADAG Group, Essel Group etc. The Net asset value (NAV) of some schemes fell as much as 53% followed by the delay in the payments of interest by DHFL. Around 20 debt funds had exposure of more than 10% in DHFL. DHFL Pramerica funds had exposure of more than 30% of their portfolio in DHFL. They were hit very hard by the crisis. Similarly the UTI MF and Reliance MF had the largest exposure to DHFL paper at Rs 1736 Cr and Rs 1182 Cr respectively. Mutual fund industry had a collective exposure of Rs 5236 Cr towards the DHFL paper. The funds have markdown the value of their holdings by 75-100% in DHFL in line with industry norms.

The DHFL effect: How Debt fund NAVs plunged

When DHFL defaulted on interest payments last week, the net asset values of many debt funds fell. Funds that had held large quantities of DHFL's securities fell the most. The following is the list of 10 funds that were hurt the most.

Fund Name	DHFL Exposure in %	Fund AUM (Rs Cr)	NAV % Impact *
DHFL Pramerica Medium Term	37.41	34.51	-52.99%
DHFL Pramerica Floating Rate	31.94	13.10	-48.39%
Tata Corporate Bond	28.21	184.06	-29.69%
Baroda Treasury Advantage	21.16	542.19	-17.15%
Principal Low Duration	19.24	240.61	-16.58%
DHFL Pramerica Low Duration	20.12	309.16	-16.57%
DHFL Pramerica Short Maturity	30.46	300.13	-13.55%
Edelweiss Corporate Bond	15.00	149.57	-13.40%
BNP Paribas Medium Term	14.84	139.39	-12.88%
Tata Medium Term	14.60	61.60	-12.31%

* From 3rd- 4th June 2019 | All the above schemes are open-ended

Source: Morningstar

Future Ahead

The investors response may be over reaction also, who are dumping the debt funds in hordes. It is estimated that investors' exposure to the Non- banking finance companies (NBFCs) and Housing finance companies (HFCs) is down by around 18% since Sept 2018. Let us look at the other side of the coin also. The total assets under management (AUM) of debt funds are Rs 13.24 Lakh Crore, which is about 51% of the total mutual fund industry AUM of Rs 26 Lakh Crore. This is substantial and underlines the faith reposed by investors in such schemes. Out of this Rs 13 Lakh Crore, around 80% of the debt is in the safest investment category. Further only a handful of these Non-banking financial companies and Housing finance companies are facing problem regarding repayments of their debt obligations. The exposure to stressed assets of the companies like ADAG Group, Essel group, IL&FS, DHFL and Cox and Kings etc amounted to 1% of the debt AUM. In some of the cases the repayment has only been delayed and will be repaid in coming times. There are a few very sound names also in the industry like Bajaj Finance and HDB Financials.

There is another reason to cheer also. The repo rate and broader interest rates are largely on downtrend since 2014. In last 5 and half years the rates have decreased from 8.00 % to 5.75 %. This is a very significant reduction in the interest rates. As elaborated in previous sections the decline in interest rates augurs well for the bond prices. The declining interest rate leads to increase in prices of bonds leading to capital gains for bonds/ debt holders.

RBI RATE CUT PATTERN

Date	Repo Rate
6 Jun 2019	5.75
4 Apr 2019	6
7 Feb 2019	6.25
1 Aug 2018	6.5
6 Jun 2018	6.25
2 Aug 2017	6
4 Oct 2016	6.25
5 Apr 2016	6.5
29 Sep 2015	6.75
2 Jun 2015	7.25
4 Mar 2015	7.5
15 Jan 2015	7.75
28 Jan 2014	8

How to select debt funds in future

First of all the investors should realize that the debt funds are not fixed deposits. They come with inherent risk with them as mentioned above and can give negative returns also. While selecting the debt funds one important point to remember is that, the fund size and its concentration in various issues should be thoroughly checked. A large fund with diversified bets is the best choice. In previous section we mentioned that the NAV of DHFL Pramerica's funds declined by more than 50% because they were heavily invested in DHFL paper, which was facing problems. According to Morningstar data, the average size of schemes that fell by less than 1 per cent was around Rs 2,500 Crore.

Similarly while the past performance of an equity fund is worth looking into while the same may not make much sense for a debt fund. This is because the interest rates are volatile and may change over a short period of time. If a debt fund has given good return in one year, the chances are high that it may not give good returns in next year.

Expense ratio of the fund should also be heeded. After all, your take home is after the expenses have been deducted from the gains. Investment horizon depends on a number of factors, like what goal you want to achieve with debt investment. What is the future outlook of interest rates? If interest rates are trending down it is better to take longer duration debt funds rather than shorter one. Another important point to note is the theme of the debt fund. Whether it invests in good quality issues or invests in junk bonds etc. Ratings can also be checked of the issues in which the fund invests. Though these ratings should be taken, with a pinch of salt. One can also use ratios such as standard deviation, Sharpe ratio, alpha, and beta to analyze a fund. A fund with higher standard deviation and beta are riskier than a fund with lower beta and standard deviation. A higher Sharpe ratio means it gives higher returns on every additional unit of risk taken. Beta denotes the sensitivity of the mutual fund to market risk. Alpha is incremental return over the benchmark return. Last but not the least the risks involved in the debt fund should also be pondered over.

Conclusion

Overall the debts funds are here to stay. The sheer amount of AUM in debt funds is humongous. They cannot be wished away just like that. However before investing in them, one has to do his own thorough due diligence.

Have a happy, safe and profitable investing!!!

References

1) Indian Mutual Funds Handbook: A Guide for Industry Professionals and Intelligent Investors, by Sh Sundar Shankaran
2) www.cleartax.in
3) www.livemint.com
4) www.Fundsindia.com
5) www.rbi.org
6) Business line

About the author:

Manish Yadav is Manager (Research) at State Bank Institute of Credit and Risk Management, Gurugram. He has banking experience in Banking Operations, Credit and Micro finance. He is PGDM from IIM Lucknow and CFA Level 3 pass also.