Dealing with a fall in debt funds

Here's what the latest IL&FS downgrade and other older downgrades tell us about investing in debt funds

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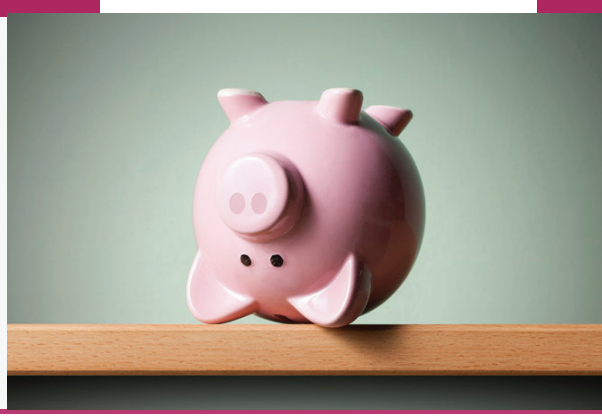

While investors in equity funds come in with the full understanding that the stock market is a risky and volatile place, debt investors in India are used to high, guaranteed returns from bank deposits and small-savings schemes that pay out interest like clockwork.

The last few years have highlighted just how different debt mutual funds really are from these fixed-income products that retail investors are used to.

Returns for debt funds that invest in government securities have seesawed in the last five years as interest rates rose, fell and then rose again. And returns on liquid, short-term and debt funds that invest in corporate bonds have seen repeated NAV shocks from defaults and downgrades on the bonds they own. The latest such episode, as recently as September 2018, involved IL&FS and its group companies. Some of the major episodes from past include that of JSPL, Ballarpur and Amtek Auto.

What to do

Now, all these episodes of rating downgrades affecting debt funds have certain common features. On studying them, one can arrive at five lessons for retail investors in debt funds.

1. If you are risk-averse, avoid debt funds with exposure to bonds rated AA minus and below.
2. Don't exit debt funds in panic after a credit event. You could be converting a notional loss into a permanent one.
3. Do your homework on a debt fund's portfolio before buying it.
4. Check out the portfolio concentration in individual bonds. The higher the scheme's individual weights in bonds, the higher the credit risk. Group and sector exposures also merit attention.
5. Debt funds with larger asset sizes and institutional presence are safer than small, mostly retail funds.

While a lot of this is good advice, it isn't easy for retail investors to follow. And it certainly doesn't fool-proof your debt funds holdings from NAV blips.

For one, doing one's homework on debt-fund portfolios is easier said than done. The IL&FS episode has brought home how financially weak group entities can undermine the credit profile of a seemingly strong parent. It also showed that there can be many shades of grey in the 'structured-obligation' ratings given out by rating agencies, which can be very hard to decipher for a retail investor looking at portfolios. Now, the most that a retail investor looking at a debt-fund portfolio can do is to assess whether its overall credit profile is high with AAA, AA or A1 plus paper. But there's not much retail investors can do if their fund sees top-rated bonds abruptly downgraded to default grade.