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Dynamic bond funds better than short-term gilts

Short-term funds suit institutional investors who can time entry and exit, based on interest rate cycle

Tinesh Bhasin | Mumbai May 09, 2016 Last Updated at 22:40 IST

Longer duration gilt funds usually do well when interest rates are in a downward cycle. The reason: bond prices rise when the interest rate falls. But, this time, the short-term gilt funds have fared better if you compare one-year returns. While the short-term gilt fund category has 9.58 per cent returns, the medium- and long-term has 7.98 per cent.

When yields were hardening for long-term government securities (G-secs) between July and December, yields on short tenure G-secs remained steady, according to Akhil Mittal, senior fund manager at Tata Mutual Fund. This led to a decline in bond prices during the period, hitting bond investors and debt mutual funds that invest in long-term G-secs. That's why short-term gilt funds saw better returns comparatively.

The high returns, however, were not entirely due to interest rate movements. Typically, short-term gilt funds should have an average portfolio maturity between one and three years. But, some funds took a call on interest rates and kept the average portfolio maturity at five years, leading to better returns. “Funds can do that if the scheme information document doesn’t explicitly states that maturity will be restricted. But, if an investor wants higher maturity in the first place, he would have opted for more aggressive medium-term funds,” says Mittal.

For individual investors, these funds don’t turn out to be an ideal choice. To benefit from gilt funds, an investor needs to have a deeper understanding of bond market and a view on interest rate movement. “Only then can the person enter and exit a fund at appropriate time. Else, he won’t be able to make higher returns compared to other fixed income products,” says Vidya Bala, head of mutual fund research at FundsIndia.

The assets under management (AUM) of these funds vary substantially month-on-month, according to Dhaval Kapadia, director (investment advisory) at Morningstar India. “A retail investor needs to be in a fund that has some consistency of AUM. Smaller AUMs can restrict the flexibility of a fund manager,” says Kapadia. The varying AUM also means these funds are used by institutional investors who take a call on interest rate movements and quickly move in and out of the fund.

“If at all someone wants to benefit from interest-rate movements, the investor should look at long-term gilt funds and remain an investor for 18-20 months,” says Bala. She adds that only those investors who have an advisor can go for such strategy. Analysts and financial planners say retail investors should stay away from gilt fund category altogether – be it short, medium, or long term.

“These are actively managed funds that are very sensitive to interest rate movement and are highly volatile,” says Vishal Dhawan, founder and chief executive officer at Plan Ahead Wealth Advisors. There have been periods when their returns were even negative.

Dhawan suggests that for the long-term investors should look at dynamic bond funds. Dynamic bond funds are versatile. Depending on the interest rate movements, the fund manager constructs the portfolio. In a rising interest rate environment, he might add more of corporate bonds. In falling interest rate cycle, he would add more of long-term gilt papers. A mix of different papers also add stability to the portfolio.