Build debt fund portfolio diversified across duration

Take limited exposure to longer-duration funds in coming year

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Debt mutual funds turned in a strong performance in 2024, with longer-duration funds leading the way. In 2025, while rate cuts may begin, the cycle is likely to be a truncated one.

Experts suggest not going overboard on longer-duration funds and instead building a portfolio diversified across duration.

Drivers of performance in 2024

Both dropping bond yields and high accruals contributed to performance. "The yield of the 10-year benchmark government security (G-Sec) dropped from around 7.2 per cent to around 6.8 per cent, creating market gains. In addition, reasonable accrual levels also supported the performance of debt funds," says Joydeep Sen, corporate trainer and author.

The global environment was also conducive. "The decline in global inflation, receding from post-Covid highs, created an environment where long-term interest rates dropped in anticipation of central banks' cuts," says Mahendra Kumar Jajoo, chief investment officer-fixed income, Mirae Asset Investment Managers.

Tight liquidity led to higher short-term rates. "Overnight rates have been around 6.5–6.75 per cent, as system liquidity has been mostly in deficit. Short-term instruments like the 3-month commercial paper and certificates of deposit yielded close to 7 per cent, leading to high average returns in liquid and money market funds," says Sandeep Bagla, chief executive officer, TRUST Mutual Fund (MF).

Inclusion in overseas bond indexes also played a part. "The inclusion of Indian bonds in JP Morgan indices, which brought around ₹1 trillion in inflows, drove performance," says Devang Shah, head-fixed income, Axis Mutual Fund.

ATTRACTIVE RETURNS OVER PAST YEAR

Fund category	Returns (%)			
	1-year	3-year	5-year	10-year
Long Duration	10.7	6.4	6.3	7.3
Gilt fund with 10-year constant duration	9.2	5.8	6.3	7.9
Dynamic bond	8.5	5.9	6.2	7
Medium duration	8.1	6.2	6.1	6.7
Short duration	7.3	6.1	6.1	6.7
Money market	7.3	6.3	5.7	6.6
Liquid	7.2	6.3	5.2	6.2

Source: Navigation RA

Maintain allocation to debt

Investors must maintain some allocation to debt funds in 2025. They can serve as a defensive asset class amid high equity valuations. "Debt funds provide flexibility to rebalance one's portfolio during equity market corrections. For short-term goals, debt continues to be the most appropriate asset class," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Positive drivers

The Reserve Bank of India (RBI) recently shifted to a neutral stance and cut the cash reserve ratio (CRR). Experts believe that a rate-cutting cycle by the central bank in 2025 can significantly influence fixed-income performance.

"We expect the RBI to cut rates to stimulate growth, which will be positive for fixed income," says Jajoo.

Shah concurs. "We expect a 50-basis point rate cut in the next six months owing to slowing GDP growth. Further fiscal consolidation by the government, with an anticipated fiscal deficit below 4.5 per cent for FY26, will lead to strong bond demand-supply dynamics," he says.

Negative factors

Geopolitical factors could impact returns of debt funds. "Geopolitical instability, higher inflation and fiscal deficit due to tariff increases, and debt scare in the US is a possibility, especially after Donald Trump assumes office in January 2025," says Jajoo.

Bagla too believes that imposition of tariffs by the Trump Administration could increase global inefficiencies, lead to inflationary impulses, and drive yields higher.

Global central bankers, while reducing the cost of money, are simultaneously shrinking the size of their balance sheets. "Diminished global liquidity can adversely affect sentiment," says Bagla.

Shah is of the view that if the rupee depreciates significantly, the RBI may slow the pace of rate cuts to avoid unnecessary depreciation.

Tilt towards longer-duration funds?

Tilting one's portfolio towards longer-duration funds may not be advisable in 2025. "We expect the RBI to cut rates in February 2025, but it is likely to be a shallow rate-cut cycle, with 50–75 basis points cut in 2025. Longer-term bonds do not appear to have much room for appreciation as inflation expectations are still not firmly anchored," warns Bagla. Moreover, a part of the bond rally has already taken place in anticipation of cuts.

Dhawan warns that investors looking to buy longer-duration funds need to be mindful of potential volatility. "They may also not see significant capital appreciation unless growth slows down rapidly," he adds.

Diversify across duration

Instead of chasing past year's performers, pay heed to your investment horizon. "Choose a fund whose portfolio maturity matches your investment horizon. For instance, if the maturity is three years, the horizon should be at least two years or more. Avoid investing in longer-duration funds for a short horizon," says Sen.

Build a portfolio diversified across duration. "Allocate 30 per cent to longer-duration funds and 70 per cent to low and short-duration funds. Avoid over-allocating to one type of fund," says Jajoo. He also suggests that investors move out of longer-duration funds after the initial rate cuts. In 2025, inflation is likely to be under control but growth may weaken. "Allocation to dynamic bond funds, and short to medium term funds, including corporate funds, can help capture the interest rate cycle," says Shah. According to him, investing in dynamic bond funds allows investors to play all parts of the rate cycle.

Do's and don'ts

Be prepared for some volatility in your fixed-income portfolio. Keep an eye on the US Federal Reserve's monetary policy actions, the rupee's behaviour against the dollar and other currencies, and the new US President's policies.

Think twice before taking credit risk. "Lower-rated bonds may not be as liquid and may also carry higher default risk," says Dhawan.

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