

Dynamic bond funds misfire

Amid the bond market's season of woes, dynamic bond funds appear to have badly miscalculated the payoffs from the rate-cutting cycle

by Sanket Dhanorkar

The bond markets have witnessed severe dislocation in recent months. Despite a supportive macro-economic backdrop—including sharp rate cuts, improved sovereign ratings, and moderating inflation—bonds have behaved erratically. Contrary to expectations of buoyancy in bond prices, bonds across maturities have come under selling pressure. Bond yields have risen, instead of cooling down. Bond fund investors needed agility to navigate this tricky scenario. Dynamic bond funds were the vehicle of choice for many. Alas, they were caught off guard again.



or volatile and the investor has moderate risk tolerance.”

Invariably, however, dynamic bond funds are unduly reliant on the declining phase of the interest rate cycle. This year also promised much, and most dynamic bond funds were well-positioned to gain from the rate-cutting cycle that began in February. With inflation softening and foreign capital flowing into government bonds following India's entry into global bond indices, there were reasons to be optimistic. The Reserve Bank of India (RBI) has so far cumulatively cut rates by 100 basis points (bps). But following the front-loaded rate cut in June, the RBI's subsequent cautious stance and actions have spooked investors, dampening hopes of further easing. Additionally, the 100 bps cut in Cash Reserve Ratio (CRR) reduced the chances of the RBI conducting Open Market Operations (OMOs) to purchase bonds. This put a lid on demand for bonds, contributing to rising yields.

Moreover, expectations of increased debt supply on higher government borrowing following anticipated rationalisation in GST rates also pushed bond prices lower. Changes in investment norms for pension funds and banks' held-to-maturity (HTM) portfolio have curtailed institutional appetite for long-duration bonds, suggests Axis Mutual Fund in a report from August. The central bank's tone in recent communications also suggests it will proceed cautiously for any further rate cuts. "RBI's approach has been different in this cycle, upfronting the easing in order to facilitate quicker transmission,

The party that never was

Dynamic bond funds aim to be all-season offerings. They seek to deliver returns across cycles. These funds actively manage the interest rate risk by constantly shifting between instruments of different maturities, according to expected movement in interest rates. When interest rates fall, bond prices rise, and vice versa. Longer tenure bonds are most sensitive to interest rate changes.

Dynamic bond funds switch to longer tenure bonds when rates are expected to fall, to capture the subsequent price gains. When rates are expected to harden, they retain the flexibility to pursue shorter tenure bonds, where the interest accrual can provide cover for lower bond prices. Santosh Joseph, CEO and Founder, Germinate Investor Services, asserts, "In the softening phases of the rate cycle, dynamic bond funds can fetch not only accrual but also capital gains arising from rising bond prices."

Nisreen Mamaji, Founder, MoneyWorks Financial Services, says, "Dynamic bond funds may be recommended as a tactical part of the fixed income portfolio, especially when the interest rate outlook is uncertain

Amid rate cuts, short tenure bonds led

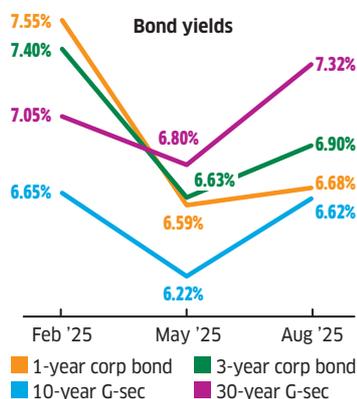
This divergence underscores the fallacy that rate cuts always benefit long bonds.

Returns since	Performance in current easing cycle	
	Nifty Corporate Bond Index A-II	CRISIL Long Duration Debt A-III Index
Last 1 year	8.30%	8.10%
Year-to-date	9.10%	8.10%
1st rate cut (7 Feb)	9.30%	8.90%
2nd rate cut (9 Apr)	8.40%	4.80%
3rd rate cut (5 Jun)	4.40%	-4.70%

SOURCE: ACE MF, Franklin Templeton. Data as on 31 July, 2025. Nifty Corporate Bond Index represents short tenure bonds. A-II and A-III signifies level of interest rate and credit risk in underlying instruments on the index.

Early gains wiped out

Long-term government bond yields have reverted to levels seen prior to the commencement of the rate cut cycle.

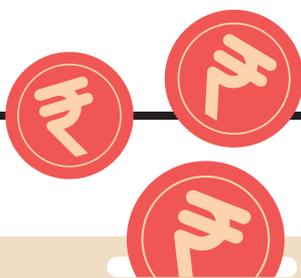


SOURCE: AXIS MF

but then changing communication to tone down future expectations from monetary policy," observes Suyash Choudhary, Head—Fixed Income, Bandhan AMC.

With the party appearing to have come to a swift conclusion, bond markets have thrown a tantrum. A sell-off has ensued, wiping out most of the gains of previous months. Despite a cumulative 100 bps rate cut between February and now, the 10-year benchmark yield has reverted to levels seen prior to the commencement of the rate-cutting cycle. This pronounced steepening of the yield curve highlights the extent of dislocation currently impacting the bond market, observes the Axis Mutual Fund report. The outcome is that the payoff many expected from a rate-cutting cycle has not materialised.

Dynamic bond funds have not been spared. Data as of 1 September shows that medium-duration funds, corporate bond funds, and short-duration funds have led the way, fetching a



healthy return of around 5.42-5.54% year-to-date. Meanwhile, gilt funds and long-duration funds have struggled, clocking 1.85% and 1.17% returns, respectively. Dynamic bond funds have delivered 3.55% during this period. The last three months have particularly put bond funds on edge, with dynamic bond funds joining gilt funds and long-duration funds in seeing losses. Over the past year, medium-duration funds, corporate bond funds, and short-duration funds have averaged 8%, while dynamic bond funds have clocked 5.8%.

“This divergence underscores the fallacy that rate cuts always benefit long bonds. Thus, managing duration—not merely extending it—may be the key,” suggests Rahul Goswami, Chief Investment Officer and MD, India Fixed Income, Franklin Templeton.

Many dynamic bond funds have been pushed into a corner as these had taken a front-foot stance amid rate cut expectations. As per Value Research data, the average maturity profile of the funds ranked among the top-10 performers fell from 12.3 years at the end of December 2024 to 10.3 years by March 2025. This was further reduced to 8.7 years by June 2025. The Macaulay Duration—a measure of interest rate risk—also decreased from 6.4 years at the end of December 2024 to 6.3 years by March 2025, and further to 5.2 years by the end of June 2025. This indicates steadily moderating portfolio sensitivity to interest rate changes.

However, many funds have continued holding on to longer maturity bonds for longer. The funds ranked among the bottom-10 saw average maturity jump from 18 years at December-end 2024 to 20.85 years at March-end 2025. The Macaulay Duration also spiked from 8.52 years to 9.64 years during this period. These reduced the portfolio duration subsequently, but remain elevated. This suggests that dynamic bond funds are still betting on yields to cool off.

Bandhan Dynamic Bond Fund made the boldest bet amid this rate-cutting cycle, steadily running the highest duration among its peers. The bond market’s sombre mood has not doused its stance. The fund manager remains confident that he is playing the cards right. “In our view, it is still too early to adopt a full passive carry book (accrual) strategy. These are more end-of-cycle plays, and with the bulk of global growth slowdown underway currently, as well as local monetary policy still in play, we think we are still far from the end of the cycle,” Choudhary asserts.

DSP Strategic Bond Fund, which until a few months had also been betting big on duration, has moderated its stance slightly, yet remains squarely in the duration camp. “We did not expect 10-year yields to rise above 6.40%. Today they are at 6.60%,” the fund house acknowledges in a note. “We maintain that yields will fall lower, but one needs to play the long game to ride volatility.”

Axis Mutual Fund opines that the current bond market dislocation presents a compelling short-term tactical window for duration-led gains. It suggests that investors may look to take advantage of this anomaly for a tactical rally of 15-25 bps.

Laggards bet aggressively on longer duration bonds

Dynamic bond funds that took a conservative stance have emerged among table toppers.

	Portfolio average maturity (years)			Portfolio Macaulay Duration (years)		
	Dec '24	Mar '25	Jun '25	Dec '24	Mar '25	Jun '25
Top 10 performers	12.3	10.3	8.7	6.4	6.3	5.2
Bottom 10 performers	17.9	20.9	17.4	8.5	9.6	8.3

Some funds manage to deliver strong gains

Scheme name	Returns	
	YTD	1-year
360 ONE Dynamic Bond	5.5%	8.1%
Nippon India Dynamic Bond	5.2%	7.7%
ICICI Prudential All Seasons Bond	4.8%	7.5%
Mirae Asset Dynamic Bond	5.2%	7.4%
JM Dynamic Bond	5.1%	7.3%

Others have felt the heat

Scheme name	Returns	
	YTD	1-year
DSP Strategic Bond	2.3%	4.5%
HDFC Dynamic Debt	2.4%	4.5%
Union Dynamic Bond	1.8%	3.9%
Canara Robeco Dynamic Bond	1.7%	3.3%
Bandhan Dynamic Bond	0.5%	2.1%

Data as on 31 Aug 2025; YTD: Year-to-date; SOURCE: Value Research

Dynamic bond funds' agility is often constrained by the liquidity in underlying bonds. High exposure to corporate bonds may hinder a fund's ability to switch its stance easily.

Is dynamic the way to go?

Financial advisers remain sceptical of the agility promised by dynamic bond funds. Basavaraj Tonagatti, Founder and Partner, BasuNivesh Fee-Only Financial Planners, asserts, “The main issue is that these funds depend heavily on the manager’s ability to predict interest rate and inflation cycles accurately. Such perfect timing is nearly impossible consistently, making them less dependable for long-term investors.”

Rushabh Desai, Founder of Rupee with Rushabh Investment Services, insists that most dynamic bond funds are not true-to-label. “They typically remain invested in medium-to-longer maturity bonds, and shy away from shorter duration bonds.” This

makes them vulnerable to quick erosion of gains if interest rates or yields don’t move as expected. Besides, dynamic bond funds’ agility is often constrained by the liquidity in underlying bonds. High exposure to corporate bonds, particularly, may hinder the fund’s ability to switch its stance easily.

Kunal Valia, Founder of investment advisory firm Statlane, asserts, “It is not worthwhile to take on the added risk, given the poor track record of dynamic bond funds in generating excess return relative to short duration or corporate bond funds.”

Experts believe that a more reliable approach to capturing opportunities at both ends of the spectrum is to use a combination of short-term debt funds (such as low-duration or corporate bond funds) along with long-term options (such as gilt funds and long-duration funds). “More often than not, a well-structured allocation across short- and long-duration funds ends up being both easier to manage and more in line with long-term financial goals than trying to time the market through dynamic strategies,” argues Tonagatti.

Vishal Dhawan, Co-Founder, Plan Ahead Wealth Advisors, says, “We prefer to use a core and satellite fixed income approach with segregated fixed income strategies based on our view on interest rates and credit, rather than a single dynamic bond fund.” This approach gives Dhawan greater control over aligning the portfolio with the client’s specific needs. Using segregated vehicles can also be cheaper than a dynamic bond fund, he suggests.

Goswami of Franklin Templeton also

suggests that a ‘barbell’ strategy might offer a balanced and flexible approach. At one end of the barbell, short-duration instruments up to one year could provide a buffer against market volatility. On the other end, longer maturity bonds beyond 15 years can be selectively added which might enhance portfolio yield without significantly increasing the aggregate portfolio duration. “The barbell strategy improves agility, manages risk effectively, and may avoid downsides of chasing duration during rate cut cycles,” he contends.

Skip debt funds altogether?

To be sure, many financial advisers have sworn off debt funds altogether. Revised tax norms now levy tax at slab rates on any gains from debt funds. This makes these tax-inefficient for those in higher tax brackets. Hemant Beniwal, Director, Ark Primary Advisors, says, “We were recommending these funds before the change in taxation, but most of our clients are in the highest tax brackets, so we are considering alternatives based on their requirements and time horizons.” Many have now shifted to hybrid funds like arbitrage funds, or equity saving schemes and income plus arbitrage funds. “Dynamic bond funds used to be part of our fixed income allocation, but we have curtailed allocations in this category. Instead, we are considering arbitrage, and income plus arbitrage funds,” says Amol Joshi, Founder, PlanRupee Investment Services.

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