



# Harness the power of debt funds to meet your key financial targets

Debt funds help achieve short- to medium-term goals if your risk profile aligns with your investment horizon

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Most investors associate mutual funds with equities, but debt funds can also play a key role if used correctly. They are particularly useful for short- to medium-term goals, offering better yields and tax efficiency than bank savings or deposits. With 16 debt fund categories available, the key is to choose one that aligns with your investment objectives.

For goals ranging from a few months to a few years, advisors often suggest shifting funds from equity to debt to protect the corpus from stock market volatility. Here's a look at popular debt fund categories and how they can be used.

## For instant liquidity

If you need to park money for a few days or weeks, consider overnight and liquid funds—the shortest-duration debt categories, ideal for cash management and money you might otherwise leave idle in a savings account. Overnight funds invest in securities that mature the next day, carry virtually no interest rate risk, and are among the safest mutual fund options. They provide the simplest, lowest-risk parking spot for short-term funds. Liquid funds extend the investment horizon slightly, allowing investment in instruments that mature in up to 91 days.

"With bank savings rates languishing around 2.5%, liquid funds can offer anywhere between 5.5% to 6.5% returns," said Vikram Dalal, managing director at Synergie Capital.

"Liquid funds are a good option to park emergency funds as these offer better returns than bank fixed deposits and can be accessed at a short notice," said Vishal Dhawan, founder of Plan Ahead Wealth Advisors.

These funds suit investors, requiring emergency money to earn returns without being locked up, accessible on a day's notice. If you redeem before 3:00 pm, the amount is credited the next business day. You can also redeem up to ₹50,000 per investor per day instantly, with funds hitting your account the same day.

## For short-term goals

If your funds are not needed for 3-12 months, consider ultra-short duration and money market funds—the next step up the maturity ladder. These can fund short-term goals such as insurance premiums, minor home renovations, or upcoming travel, and also serve as a bridge investment while waiting for better equity or long-term debt opportunities. Ultra-short funds hold instruments with a Macaulay duration of 3-6 months, while money market funds extend up to one year. Returns generally range from 6.5% to 7.5% based on market

## How to navigate debt funds

Fund type	Investment horizon	Interest rate risk	Credit risk
Overnight fund/liquid fund	Up to 3 months	Very low	Very low
Ultra short/money market	3-12 months	Low	Very low
Short duration	1-3 years	Moderate	Low
Medium duration^	3-4 years	Moderately high	Moderate to high
Corporate bond / banking & PSU	3-5 years	Moderate	Low to moderate
G-sec funds/long-duration funds	7-year-plus	High to very high	Lowest

^Avoid portfolios with high credit risks

### How to check credit quality of portfolio

See credit ratings of the investee bonds

Credit rating	Credit quality
Sovereign rating	Highest
AAA (+/-)	High
AA (+/-)	Moderately high
A (+/-)	Moderate
BBB (+/-)	Low
Below BBB-	Below investment grade

### Checklist

- Match your investment timeline with the fund's maturity in the factsheet
- Check Macaulay duration in fund factsheet
- Credit quality can be gauged from share of AAA-rated papers

### What is Macaulay duration

- Approximate fund maturity based on the cash flows of its investee bonds
- Longer duration means more vulnerable to interest rate changes

### Avoid

- Investing in debt funds to chase returns
- Some funds may take higher credit risks
- Watch out for low-quality credit papers

### How are debt funds taxed

- Taxed at investor's slab rate regardless of holding period

conditions. As of 23 October 2025, the one-year category average for ultra-short duration funds was 6.9%, according to Value Research.

## When goal is a few years away

Short-duration funds invest in bonds and other debt instruments with maturities of one to three years, making them suitable for short-term goals. They balance safety with slightly higher returns, holding a mix of government securities (G-sec), PSU bonds, and high-quality corporate papers. Yields are better than liquid or money market funds, typically ranging from 6.5% to 8.5%.

As of 23 October 2025, the one-year category average return for short-duration funds was 7.86%."To

select the right short-duration funds now, investors should look for funds that have higher AAA and AA corporate bond holdings rather than gilts or floating rate bonds. Both AAA and AA corporate bonds now offer yields that are attractive relative to the past," Aarati Krishnan, head of advisory, primeinvestor.in. said.

## Opt for longer-duration funds if your investment horizon is long, but always steer clear of high credit-risk papers

Ensure the fund's Macaulay duration roughly matches your investment horizon. For example, if you need the money in two years, choose a fund with a two-year duration. Investing in a longer-duration fund and withdrawing early can lead to higher mark-to-market volatility, which is undesirable for short- to medium-term goals. The other option is medium dura-

tion funds carry Macaulay duration of 3-4 years. "However, be cautious in this category as funds typically take more credit calls in this category," said Ashish Chadha, a registered investment advisor.

## What is Macaulay duration

Macaulay duration is the average time it takes to recover your investment in a fund's bonds through interest and maturity. Longer durations increase sensitivity to interest rate changes, causing short-term volatility, making such funds less suitable for short-term goals.

Shorter-duration funds are less affected, as bonds mature sooner and can be reinvested at new rates. Investors with shorter horizons should stick to shorter-duration funds, while those with longer horizons can accept higher interest rate risk for potentially better returns.

## For 3-plus-year goals

Once your goal horizon stretches beyond three years, you can afford a little more duration and volatility—in return for better yields. That's where corporate bond funds, banking, and PSU debt funds come in.

Corporate bond funds invest predominantly (at least 80%) in AAA-rated instruments. Banking & PSU funds, on the other hand, invest mainly in public sector bank and PSU bonds, which come with the comfort of sovereign backing. These funds' annual yield right now is between 7.5% and 8.5%, based on one-year returns as of 23 October 2025.

The category average one-year return for banking & PSU funds was 7.84%. The category average one-year return for corporate bond funds was 8.12%. These categories work well for medium-term goals. They also serve as a core debt allocation in a conservative portfolio, balancing risk and return more effectively than shorter-duration funds.

## Patient money

Long-duration or G-sec funds invest in government securities with maturities of 10 years or more. These bonds are highly sensitive to interest rate movements—meaning even a small change in rates can cause large swings in their prices. That's what makes them risky in the short run.

Over long periods—seven years or more—market ups and downs tend to even out, making these funds suitable for investors who can stay invested through a full interest rate cycle, ideally entering when rates are high. However, this is a tactical move, suitable only for savvy investors who can handle the associated volatility, as predicting the interest cycle over the long term is difficult.

## Takeaway

Debt funds offer another advantage over traditional banking instruments—you are not taxed on interest annually. Interest received by the debt fund is added to the fund's NAV (net asset value). Gains are taxed only when you redeem your units, and at your income tax slab rate (since indexation benefits on long-term holdings were removed after April 2023). This deferral allows your returns to compound more efficiently over time. While debt funds are recommended for very short to medium-term goals, understanding the time horizon of your goals and investing in debt funds that match this duration is crucial to maximize their benefits. Avoid funds with high credit risks, as these funds also face default risk.



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