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# Avoid chasing recent gains in long-duration funds

SANJAY KUMAR SINGH

The 10-year Indian government bond yield rose from 6.66 per cent when the US-Iran war began to a peak of 7.14 per cent. It has now retreated to around 6.76 per cent. Longer-duration debt funds have gained the most from the rally. Experts, however, warn against outsized exposure to this category.

## Macro backdrop turns supportive

The macro backdrop has improved over the past fortnight. Brent crude rose from around $70 at the start of the war to an intraday peak of $126, and has now eased to around $73 per barrel. Lower crude prices are likely to reduce the import bill, ease current account deficit-related concerns, and moderate inflation expectations.

"Steps by the Reserve Bank of India (RBI) to attract foreign flows through foreign currency non-resident (FCNR) deposits and external commercial borrowings (ECBs) by public sector undertakings (PSUs) and banks should support inflows," says Devang Shah, head of fixed income, Axis Mutual Fund.

"The government's tax relief for foreign investors on capital gains and interest income from government securities is a positive step," says Amit Modani, senior fund manager, Shriram Asset Management Company. Shah says foreign portfolio investors (FPIs) have already invested around ₹40,000 crore in government bonds after the tax changes. Indian bonds could enter the Bloomberg Global Aggregate Index, which Shah says could bring in another $20-25 billion.

Bond markets have rallied, with yields falling by about 40 to 50 basis points or more across the curve. Inflation pressure and rate-hike expectations have eased.

## Risks persist

The truce in West Asia is an uneasy one. "Investors should wait about two months for clarity," says Vishal Dhawan, founder and chief executive officer, Plan Ahead Wealth Advisors. Inflation risk remains due to potential supply-chain disruptions in West Asia and a deficient monsoon. RBI has forecast that consumer price index (CPI)-based inflation could average 5.1 per cent in 2026-27.

### Debt funds to pick

**Keep bulk of portfolio in shorter- and medium-duration funds**

Category average returns (%)

| | 1-yr | 3-yr | 5-yr | 10-yr |
|---|---|---|---|---|
| Liquid | 6.3 | 6.9 | 6.2 | 6.1 |
| Money market | 6.4 | 7.3 | 6.5 | 6.7 |
| Short duration | 5.7 | 7.5 | 6.8 | 7.2 |
| Corporate bond | 5.5 | 7.5 | 6.4 | 7.4 |
| Medium duration | 6.5 | 8.0 | 7.5 | 7.6 |

Returns are for direct plans. Returns above one year are annualised.
Source: Value Research

"Around 90 per cent of the positive impact of the truce appears to be already priced in," says Joydeep Sen, corporate trainer and author.

## Long-duration funds can be risky

Long-duration debt funds have gained the most from falling yields, but Sen says incremental returns may not be significant. He sees no strong rate-cycle argument for entering these funds now. Modani says investors should avoid large single-directional bets. "If inflation risk materialises, rate-hike expectations could build faster than expected. In that case, long-duration funds could be added in a tactical and phased manner," he says.

Sen says investors should consider these funds only if their horizon matches the fund's maturity. Modani adds that investors should have high risk tolerance and the ability to handle volatility.

## Short- to medium-duration funds for core allocation

Experts see better risk-reward in high-quality short- to medium-duration funds. "RBI measures should bring a deluge of liquidity over the next few months. Liquidity surplus should support the short- to medium-term part of the bond curve," says Shah.

Shorter-duration funds are less vulnerable to interest-rate risk. "The two- to five-year corporate bond segment offers attractive spreads compared to matching government securities," says Modani. Shah says investors should build the core portfolio with funds having an average maturity of one to five years. "Investors with a horizon of more than two years may consider allocating a portion to an income-plus-arbitrage fund of fund, as this category offers tax efficiency," says Shah.

## Credit risk funds: Higher accrual, higher risk

Credit risk funds may offer higher accrual than quality debt funds. "While a quality debt fund may have a yield to maturity of around 7 per cent, a credit risk fund may offer around 8 to 9 per cent," says Sen.

Improved corporate health also supports the case for investing in these funds. "Rating agencies' credit ratios have stayed above one since FY22, indicating more upgrades than downgrades," says Sen. These funds, however, carry credit and illiquidity risk. Dhawan says they suit only investors who are comfortable with higher credit risk. About 50 to 70 per cent of the debt allocation should be in short- and medium-duration strategies. Dhawan suggests limiting long-duration funds to around 20 to 30 per cent of the debt portfolio.

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