equaliFi ACADEMY

FII

CERTIFICATE IN
FIXED-INCOME INVESTING

Session 10 - Fixed Income Investing

Fixed Income Investment Vehicles

Comparison of Investment Channels

	Mutual Funds	PMS	AIFs
Offer	Professional services for a fee	Professional and personalized services for a fee	Investments 'with a difference' for HNIs, with relatively higher fees
Objective of Investment	Multiple Funds as per suitability of investors	Customised portfolio / mandate for HNI investors	Niche product for savvy HNI investors with understanding of risks
Description	Convenient vehicle for masses to HNIs, wide range of products	A niche version of mutual funds for HNIs, limited products on offer	A wrapper for HNIs seeking higher return and understanding the risks, regulations lighter than mutual funds
Advantage	Liquidity, professional management, mass appeal, tax efficiency in debt, convenience, tight regulation and compliance required for masses	Can be customized to client requirements, professional management	Can take more risks than mutual funds or PMS, offers diversification to HNIs, professional management

	Mutual Funds	PMS	AIFs
Drawback	Nothing, practically	Less transparent, less liquid and less tax efficient than mutual funds	Less transparent, less liquid, less tax efficient, less cost efficient than mutual funds; relatively more risky
Liquidity	Most liquid vehicle, in the form of redemption with the AMC	May involve lock-in, not as liquid as Mutual Funds	Not as liquid as Mutual Funds
Minimum Investment Required	Minimal, say Rs 5000	Rs 50 lakh	Rs 1 crore
Ownership of Investments	Trustee, on behalf of the investors	Investors directly own the individual securities in their portfolio	Investors directly own the individual securities in their portfolio
Expenses charged	Fixed charges, within SEBI defined limits, usually less than the limits	Fixed fees plus profit sharing beyond a hurdle rate	Fixed fees

Advantages of Mutual Funds over direct investment in bonds

Guiding Principles	Bank Deposit	Certificate of Deposit	Commercial Paper	Treasury Bills	Corporate Bonds	Government Securities	Mutual Funds-Liquid	Mutual Funds (Open Ended)
Preservation of Capital	√	Yes, provided it is held till maturity, otherwise market movement may impact returns, making capital go negative for sometime					√	Depends on market movements
Tax Efficiency	X	X	X	X	X	X	√	√
Liquidity	√	X	X	Yes, for wholesale	X	Yes, for wholesale	√	Depends on exit load
Transaction Cost Efficiency	√	X	X	X	X	X	√	√
Impact Cost of Transaction	X	√	√	Depends on liquidity	√	Depends on liquidity	X	X
Ease of Operation	√	X	X	X	X	X	√	√
Convenience	√	X	X	X	X	X	√	√

Accessibility: Mutual Funds are easy to access, through distributors, online, acceptance centers etc. The wholesale bond market is almost out of reach for the retail investor. The listed bonds at NSE/BSE can be accessed by retail investors, but s/he needs to be savvy to track it and understand it.

Liquidity: The bond market, beyond the AAAs, are not liquid. In mutual funds, redemption is easy, through distributor / online / centres.

Ticket Size: All ticket sizes are available, from as small as Rs 5000 to multiples of crores. SIP tickets are even smaller. Wholesale bond market deals in crore and is out of bounds of the retail investor. NSE listed bonds have affordable ticket size, but liquidity is an issue.

Option of multiple funds

- There are a plethora of funds, there is one to suit your requirement, managed by professionals. That is not the case with bonds.

Tax Efficiency in growth option over 3 years

- In bonds, most of the returns come from coupons, which is taxable at the marginal slab rate i.e. 30% + surcharge and cess. Capital gains of bonds is a small component of returns. In mutual funds, if you have a horizon of 3 years, there is significant tax efficiency.

Advantages of Bonds over Mutual Funds

Though Mutual Funds have many advantages, bonds also have an appeal, particularly for a large treasury with the bandwidth to manage the portfolio.

Bonds lead to cost saving. Only the initial transaction cost is payable, but there is no recurring cost like in a mutual fund. To be noted, there is a cost of running the treasury.

Maturities can be laddered as per cash flow horizon. In the mutual fund space, FMPs come with defined maturity, eliminating market risk at maturity. Interval Funds behave similar to FMPs.

There is a limitation of maturities, bonds are available across maturities.

Portfolio Construct

Portfolio Construct - Debt Mutual Funds

Mark-to-market or volatility risk will always be there in open-ended debt funds as the fund will always have a portfolio maturity.

MTM or volatility risk will not be there in an FMP on maturity. It will be there in the interim.

Having said that MTM risk will always be there in open ended debt funds, if you are there to a reasonable extent of time, you will not be impacted much by market movements.

Reason is, over a period of time, accruals provide the cushion against market movements, if market movement is adverse. If market movement is favourable, it will add to the accruals.

What is adequate extent of time is not defined. The ballpark is, the portfolio maturity or duration of the fund, or somewhere near to that.

Portfolio Construct - Debt Mutual Funds

If you want to benefit from yield down-tick, or have a long investment horizon, you may in invest in long bond funds i.e. G-Sec Funds, Long Duration Funds, or even Dynamic Bond Funds as the fund manager can go long on portfolio maturity / duration.

If you want relatively lesser volatility, come to shorter maturity funds e.g. Short Duration, Banking PSU, Corporate Bond.

If you want to play it even more safe i.e. lesser horizon or minimum volatility, then come to the very short end of the yield curve.

Portfolio Construct - Bonds

Take care of the credit rating and name comfort

Do ‘laddering’ i.e. various maturities, preferably to match with your cash flow requirements.

On maturity of a bond, there is no mark-to-market risk

Multiple bonds in the portfolio

- Diversify credit risk
- Multiple coupon payment dates lead to cash flows, if required

For liquidity requirements, if it is required to be sold, a reasonable face value helps to sell for a matching quantum

Recap of salient aspects

Yield and price move inversely.

In bonds / bond funds, bullish view means yields coming down. Bearish view means yields going up.

Modified duration of a bond / bond fund gives the sensitivity. It is referred to as the multiplier.

For a given movement in yields in the market (up or down), the impact on price is given by the multiplier.

Macaulay Duration is an academic concept. It is one step before the computation of Modified Duration.

Interest rate risk (or duration risk or volatility risk) can be mitigated by reducing maturity / duration.

Credit risk (or default risk) can be mitigated by higher credit rated instruments and diversification.

Mutual Funds are the preferred vehicle for investment than direct bonds. Apart from the points covered earlier, liquidity is a big issue.

Returns in a debt mutual fund comes from both accrual and mark-to-market (or duration or volatility). At the shorter end of the yield curve, MTM impact is low, hence it is mostly accrual.

Tax efficiency can be generated (assuming you are in a higher bracket) by investing in debt mutual fund growth option and remaining invested for 3 years / more.

Quiz

A securitized debt created on a housing loan is called?

A. Asset Backed Security (ABS)
B. Mortgage Backed Security (MBS)
C. Loan backed security
D. Debt backed security

Which of the following is an example of securitized debt based on a pool of potential assets?

A. Asset backed security out of Business Loans
B. Asset backed security out of Housing Loans
C. Asset backed security out of Student Education Loans
D. Asset backed security out of future Credit Card Debt

Quiz

Which of the following is the voluntary market body for the bond, money and derivatives markets?

A. CCIL
B. SEBI
C. FIMMDA
D. RBI

In a secondary market bond transaction, the accrued interest that is part of the deal, is:

A. The interest that is due to the seller from last interest payment till deal date
B. The interest that is due to the buyer from last interest payment till deal date
C. The transaction charges
D. Additional interest payable by the bond issuer after the deal

Quiz

If you have a limited amount for investment, you would prefer:

A. Mutual Funds, as the minimum investment amount is small
B. PMS, as the minimum investment amount is small
C. Buy bonds directly from the secondary market
D. None of the above

AMFI is a:

A. SRO (self-regulatory organization)
B. Body that passes rules for regulation of mutual funds
C. A body set up by an Act of Parliament
D. None of the above

My Books

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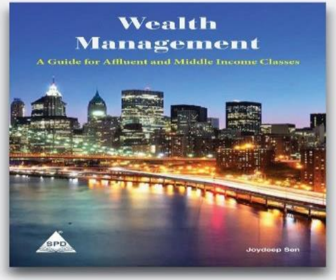

Wealth Management
A Guide for Affluent and Middle Income Classes

ISBN: 9789352137497
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Author: Joydeep Sen

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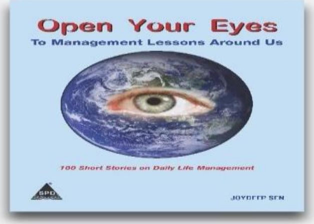
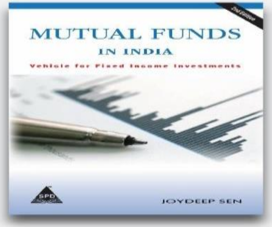
Financial Advisor, Trainer, Author, Columnist, Academician

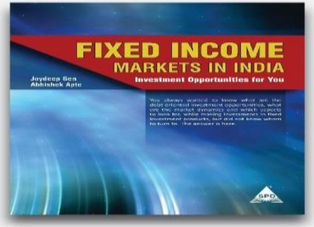
Joydeep has worked in the financial services industry for 25 years, till 2016, of which the last 13 years were with a leading MNC Bank in the Wealth Management department as Senior Vice President - Advisory Desk. Prior to the MNC Bank, he worked with various companies in the private sector. Since January 2017, Joydeep is on his own, pursuing his passion.

Joydeep writes columns regularly in various financial publications, both print and digital. Since January 2017 till July 2018, he has published 90 articles in publications like Mint, Financial Express, Moneycontrol, Cafemutual, Financial Planning Journal, etc. He does trainings for multiple organizations. He is a visiting faculty at a couple of business schools in Mumbai. Joydeep is a Certified Financial Planner and he did his MBA from Jadavpur University, Kolkata, in 1991.

He has authored three books (1) "Fixed Income Markets in India - Investment Opportunities for You", (2) Mutual Funds in India - Vehicle for Fixed Income Investments and (3) Open Your Eyes - to Management Lessons Around Us. The books have been well received by the audience.







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