Consider well-diversified credit risk funds with limited exposure

Investors should observe a few precautions, despite the likely higher returns

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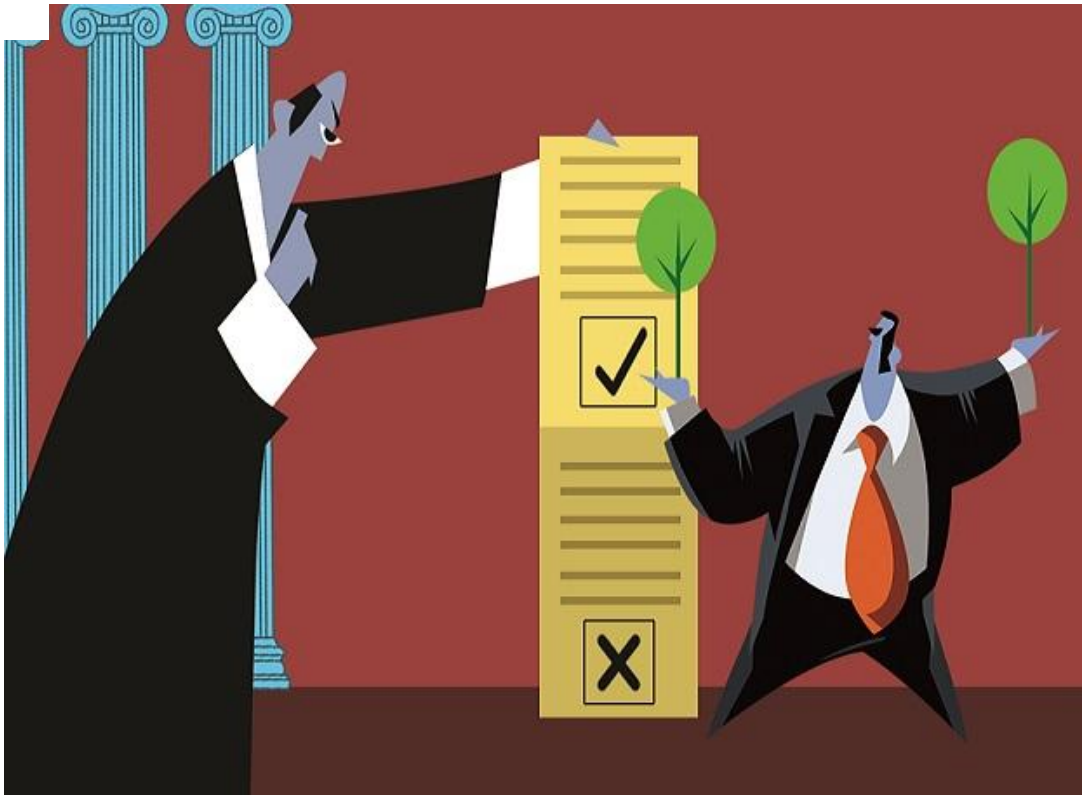

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Investors exited from credit risk funds in large numbers after Franklin Templeton Mutual Fund announced the winding up of six of its debt schemes in April. They moved to safer categories like banking and PSU and corporate bond funds. However, with the economy recovering gradually, experts say investors can consider credit risk funds again.

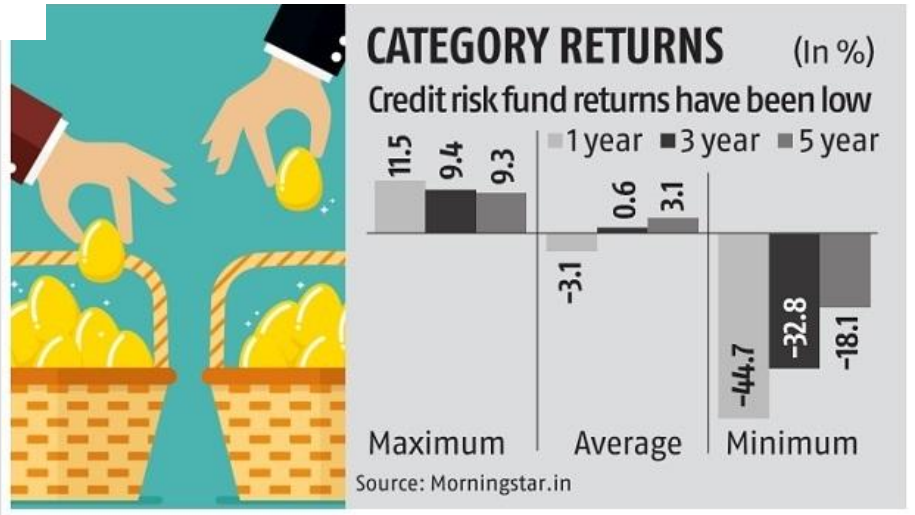
What is on offer?

Credit risk funds invest in bonds with AA and below ratings. These bonds are higher risk compared to their AAA-rated counterparts and, hence, offer higher interest. These funds run a diversified portfolio of lower-rated bonds and thereby try to earn better returns than safer categories. “Credit is an essential part of a debt investor’s portfolio, especially in a low-yield environment like the one we are in today. Investors are also better aware of the risks in these funds now,” says Devang Shah, deputy head–fixed income, Axis Asset Management Company.

Worst may be over

At the end of December 2019, the total asset under management (AUM) of this category stood at Rs 62,685.49 crore. At the end of November 2020, its AUM had fallen to Rs 28,576.95 crore, according to mutualfundindia.com. Past returns have also been poor.

However, fund houses have cleaned up their portfolios, which carry less risk today than a year or



two ago. "Investors may take limited exposure to credit risk funds out of their total fixed-income allocation," says Joydeep Sen, corporate trainer and author.

He says investors must stick to AMCs that have a track record of managing these funds. "Returns may be higher in these funds due to the higher carry yield, provided there is no default," he adds.

Selling pressure within the category has abated. The yield-to-maturity (YTM) of well-managed credit risk funds is in the 8.5-10.5 per cent range.

Even after adjusting for an expense ratio of 1.5-1.9 per cent, the net yield (expected return) is likely to be around 7 per cent or and above, higher than the 5 per cent net yield or even less available in corporate bond funds and banking and PSU bond funds.

Investing in these funds may be worth the extra risk.

"Credit markets in India are in the nascent stage compared to global markets. Hence, liquidity shocks and lack of participation are risks often seen in these funds. However, strong portfolio construction and integrated risk frameworks can help a fund manage these risks well without compromising on their return potential," says Shah.

Should you invest?

Only investors who have the necessary risk appetite should consider them. Invest with at least a three-year horizon. A longer time frame will help ride out volatility. Moreover, gains on units held for more than three years are taxed at 20 per cent with indexation, which improves returns.

Take limited exposure to these funds. "Economic activity is picking up faster than expected and major data points are surprising on the positive side. Against this backdrop, and given the current elevated yields in AA- and A-rated bond segments, credit-oriented debt funds deserve an allocation of up to 35 per cent in clients' portfolios," says Yogesh Kalwani, head of investments at InCred Wealth. Conservative investors should, however, avoid investing beyond 10-15 per cent of their debt portfolios in them.

Finally, choose well-diversified credit risk funds with limited exposure to a single issuer, and invest in more than one such fund.

Read our full coverage on credit risk funds

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