WHAT IS DEBT FUND?

Chapter 19

A BEGINNER'S GUIDE
TO MUTUAL FUNDS

Debt Mutual Funds could provide income at regular intervals

Broadly, there can be two investment goals i) To make your money grow and ii) To generate income at regular intervals. The former typically requires investment in equity funds while the latter requires investment in debt or fixed income funds. Equity funds may be a less suitable option for regular income owing to the structure of the asset class which is highly volatile with a higher risk of capital erosion. The risk is more in the short term than in the long term. Debt funds, on the other hand, are relatively less volatile with better consistency of returns. Hence they are more suitable for income at regular intervals.

The underlying fixed-income instruments in a debt fund portfolio include bonds issued by the government, corporates or banks as well as money market products (very short term debt instruments).A bond is like a certificate of deposit that is issued by the

borrower to the lender who in turn pays interest on the bond. Debt funds come in several sub-types with subtle differences that make them suitable for different purposes.

HOW DEBT FUNDS WORK

Debt mutual funds generate returns by investing in bonds or money market instruments. Returns earned by the fund are a combination of interest earned by bonds in the debt fund's portfolio and the capital gains realised by trading in the bonds on exchanges. The interest earned helps debt funds provide income at regular intervals to investors subject to availability of cash flows. Since the bonds in the portfolio are tradable like shares, prices of bonds can rise or fall, just like shares do on the stock market. If the price of a bond rises, it helps to generate higher return for investors over and above the interest income. Obviously, the opposite is also true and the price of a bond can also fall. But why would bond prices rise or fall? There can be a number of reasons. The major one is change in interest rates, or even the expectation of such a change. Suppose there is a bond that pays out interest at 9% per year. Let us assume that the interest rates in the economy fall and newer bonds start getting issued at a lower rate, say 8% per year. Obviously, the old bond would suddenly rise in demand because it pays a higher interest rate. It's price would hence rise and those mutual funds that are holding it would see the value of their portfolio or NAV (net asset value) rise.

Obviously, the reverse could happen when interest rates rise. Older bonds would lose demand vis-à-vis newer bonds. Hence value of the former would fall and mutual funds that are holding them would lose value of their portfolio or NAV. Fluctuation in the resale value is the key difference between assured returns instruments and fixed income mutual funds as the latter cannot assure returns. It also means that a debt fund may even make a capital loss if prices fall more than the interest income earned. However, a combination of interest income and potential for capital gains provide an edge to debt funds over traditional assured returns.

SUMMARY

Debt funds, also called as fixed income funds are suitable for investors who desire income at regular intervals(though this is not assured like in traditional fixed income products and is also subject to availability of cash flows). Debt funds invest in corporate, bank and government bonds besides money market instruments. These bonds are traded like shares on exchanges and their prices fluctuate based on demand and supply. The interest paid on these bonds is a key determinant of returns earned by the mutual fund besides the change in price of underlying bonds. The latter is dependent on the interest rate scenario in the economy. A debt fund can provide higher returns if the prices of underlying securities rise. The former happens when interest rates fall. The reverse is also possible when interest rates rise.

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