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Understanding

'Duration Management' of Debt Papers

– By Prof. *Simply* Simple TM

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Debt funds invest in debt papers which need to give good fixed returns & be of good quality.

Based on the interest rate outlook, the fund manager decides whether to invest in long duration papers or short duration papers.

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But how is his decision of selecting long duration papers or short duration papers connected with the interest rate outlook?

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Simply speaking, when interest rates are expected to go up,

the debt fund manager would invest in shorter duration papers

but if interest rates are expected to come down, then he would do the

opposite and invest in longer duration papers.

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Let’s understand this better.

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When a fund manager thinks that interest rates are likely to go up in the near future, it means that debt papers in the future will offer better rates of return.

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The fund manager observes that since interest rates are likely to rise soon and debt papers giving a higher interest rates would become available, he invests in papers with shorter maturities so that by the time the interest rates rise, his papers have matured and he has cash to invest in the new papers.

Now what happens when the debt fund manager believes that interest rate is more likely to come down?

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He just reverses his strategy and invests in long duration papers.

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If a debt fund manager feels that interest rates are coming down and that fresh papers in the future would bear a lower interest rates, he would naturally invest in currently available papers for a longer duration.

By doing so, his money stays invested in higher interest bearing papers even in a lower interest rate regime.

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The value of the higher interest bearing papers too would go up and the fund manager too could extract a higher price by selling it in the market!

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Hope this lesson has given you an idea of 'Duration Management' of debt papers.

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I will be glad to receive your feedback

on this lesson to understand if there any gaps.

Your feedback will help me improve my lessons going forward.

Thinking of Investment

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