LONG TERM DEBT FUNDS

Understanding why one moves into long term debt funds when interest rates begin to fall

LONG TERM DEBT FUNDS

Everyone knows that prices rise when there is increase in demand and fall with the fall in demand. The same is applicable to Bonds with long durations.

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Let's revisit the basics of Bond price and Interest relationship:

When Interest rates rise, price of bonds fall. Likewise, prices rise with a fall in interest rates

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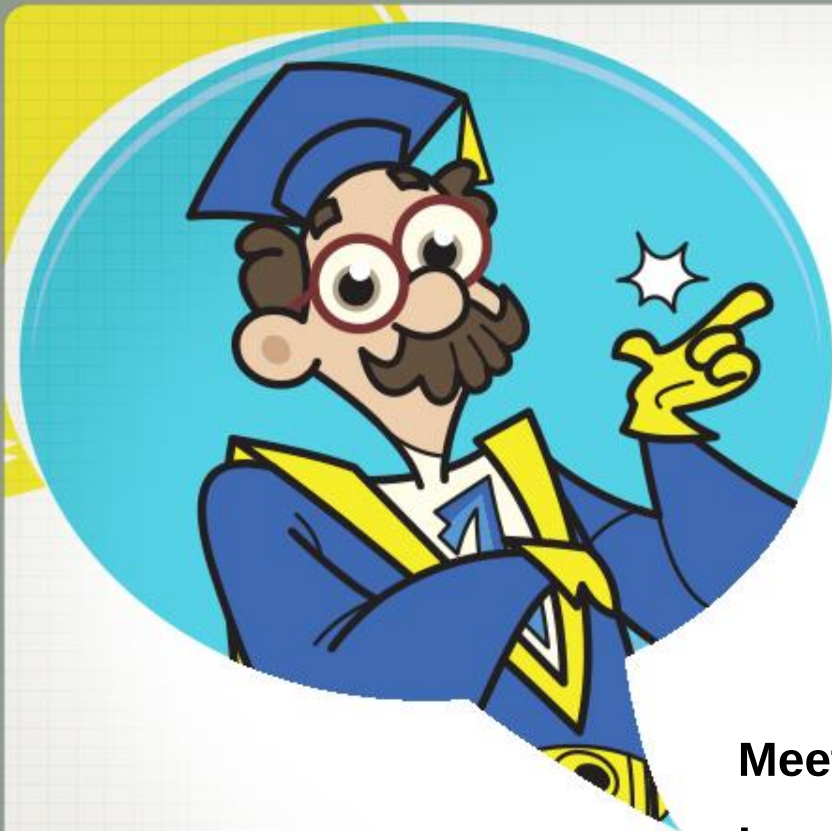

Meet the typical Indian middle class housewife who manages her house efficiently with the money that her husband gives her.

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When she expects the price of vegetables to rise, she decides to purchase large quantities of vegetables for use over a longer period.

Now, even if the price of vegetables were to go up, it would not make a difference to her as she had purchased for a longer duration because of her expectations that prices are set to rise.

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Similarly when interest rates are expected to come down, it means that the demand for bonds yielding higher interest rates would increase. Also the supply of bonds with higher interest rates will come down. Therefore the price of such bonds would go up.

So a smart fund manager would buy such bonds for a much longer duration so that he can gain from the increase in the price when interest rates go down as per his expectation.

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Thus whenever interest rates are poised to fall it makes ample sense to buy funds that hold papers of longer duration.

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Going back to our housewife example. What do you think she will do when she expects supply of vegetables in the market is likely to go up?

When supply is expected to go up, prices would come down. Hence the housewife does not buy vegetables for the long term any more.

She just buys enough for a day or two so that she can take advantage of the falling prices.

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Similarly when a fund manager expects interest rates to rise, he realizes that the prices of bonds are set to fall because of higher supply.

So he sells long duration papers and moves into short duration papers. This is exactly like what the smart housewife did when she purchased vegetables for a day or two.

Both their objectives being the same – i.e. to have the money to buy at the right time.

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Therefore when one is expecting interest rates to rise, it makes sense to invest in funds like Short Term Bond Fund which invests in papers of shorter duration.

This ensures that you are prepared with money to buy when the prices start to fall

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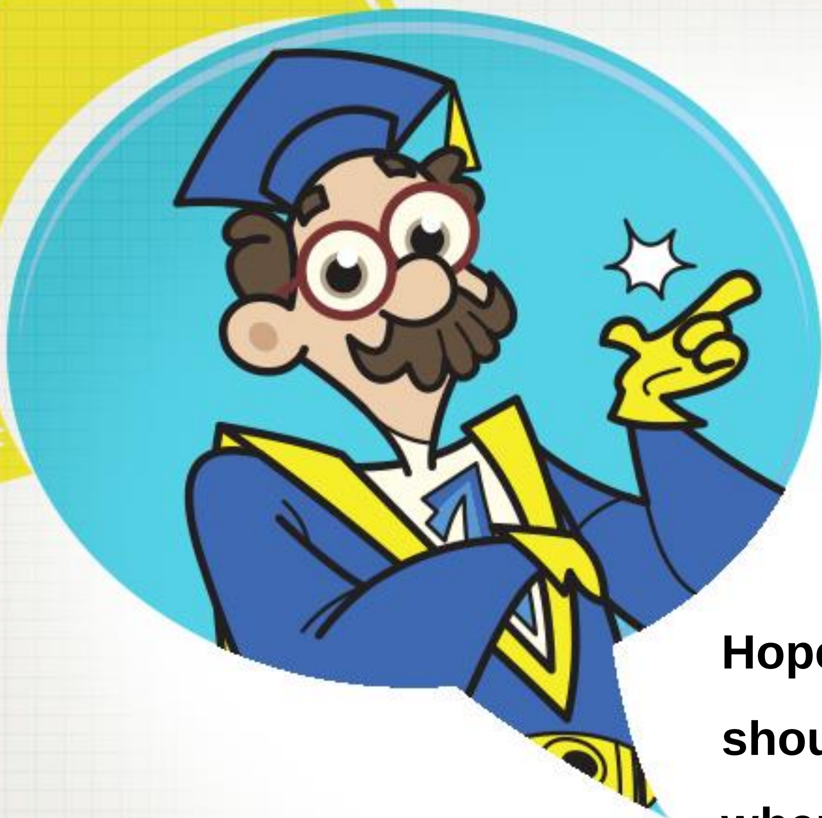

Hope this story has clarified why one should invest in long duration bonds when interest rates are expected to fall and short duration funds when interest rates are expected to rise

Thinking of Investment

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