Debt MF Portfolio Strategy

Debt funds invest in fixed income instruments, such as bonds, CPs, CDs, T-bills etc. The main factors that impact the value of debt instruments are interest rates, exchange rates, inflation and policies of the central bank. Apart from these, a weakening of credit rating of the issuer is also a source of risk for non-government debt papers.

- A Debt Fund manager has to factor in all the risk parameters and various scenarios while building a debt portfolio.
- Building of portfolio requires minute scrutiny of the macroeconomic factors & taking a call on the interest rate & yield curve.
- Debt fund managers therefore make use of Accrual strategy or duration strategy while managing a portfolio as this is a way of optimizing interest rate risk and re-investment risk, based on where in the interest rate cycle we are at the moment.

Accrual strategy

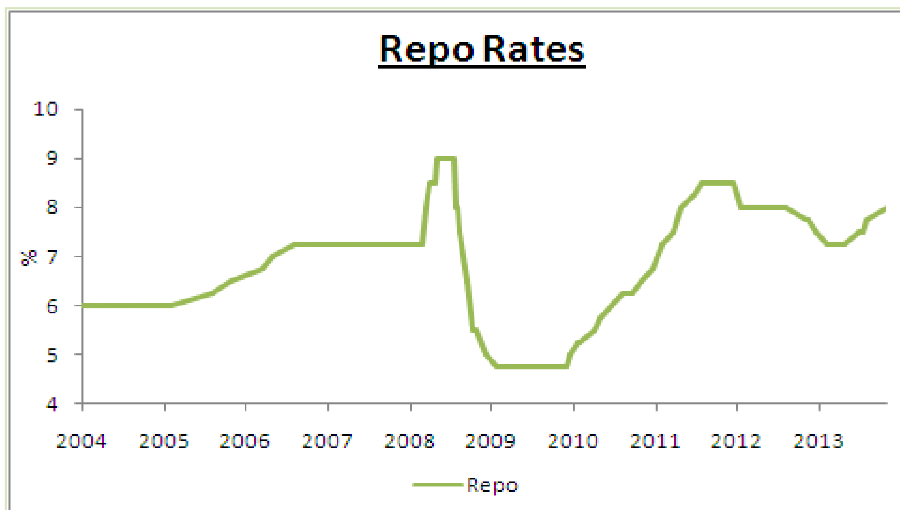
- Passive Investment strategy with the aim to get return from interest accruals not from capital appreciation
- Fund by large follows buy and hold strategy
- Focus on the papers available at a spread over the market yields
- Exposed to liquidity and credit quality risk
- In Debt category, FMPs, Ultra Short term bond funds and Short term bond funds follow this strategy while some corporate focused bond is available in market

Duration based strategy

- Active investment strategy with an aim to earn from capital appreciation along with the coupon of the bond
- Focus on interest rate movements and accordingly take call on adjusting the duration of his portfolio to maximize returns
- In declining interest rates scenario, Fund manager would opt for a relatively high duration, in an effort to maximize capital gains from rising bond prices and vice-versa
- Exposed to interest rate risk
- Generally all long term Income and Gilt Funds follow the duration based strategy

Accrual vs Duration

Accrual Strategy	Duration Strategy
Passive strategy	Active strategy
Earnings from Interest accrual targeted	Taking a interest rate call and adjusting Funds accordingly
Involves position in short term papers	Portfolio build using long term papers, mostly Gilt
Exposed to liquidity and credit quality risk	Exposed to interest rate risk
Eg - FMPs, USTF	Eg - Long term Income, Gilt fund



Source: RBI

In the period of 2008-2009, we have seen continuous decline in the repo rates while from 2010-2011 period, the repo rates were hiked on a continuous basis. The table below shows the returns given by income fund, following accrual strategy & Long term fund following duration based strategy in those periods.

Accrual Funds	20/10/08 – 21/04/09(%)*	02/07/10 – 25/10/11(%)^
HDFC High Interest - STP	10.4	**8.2**
ICICI Pru Corporate Bond- B	3.7	**9.7**
Kotak Flexi Debt	3.9	**9.6**
Templeton India ST Income Plan	7.5	**9.2**
Duration Funds		
Birla SL Income Plus	17.2	7
ICICI Pru Income Opportunities Fund	20.1	6.5
Kotak Bond Fund- Plan A	16	5.2
Reliance Income Fund	16.3	5.3

Returns are average returns in the period mentioned

*Period of Rate cuts, when Repo rates were continuously cut from 8% in Oct 2008 to 4.75% in Apr 2009

^Period of continuous rate increasing, when repo rates were continuously raised from 5.50% in Jul 2010 to 8.50% in Oct 2011

Source: ACE MF

Duration based strategies are likely to see NAVs fluctuating much more than accrual based strategies, but at the same time, in declining interest rate environments, hold the promise of higher returns than accrual based strategies. The key therefore is to understand the risk appetite and objective before determining whether to go for accrual or duration based strategies. Accrual based strategies offer a little more predictability in returns and can be selected for more conservative investors and can remain relevant for long periods of time, and need not necessarily be reviewed at different stages of the interest rate cycle. In contrast, duration strategies are perhaps better off only in periods of declining interest rates, and may disappoint in times of rising interest rates.

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