Gilt Funds

What are Gilt Funds?

- Gilt Funds are debt funds which only invest in Government bonds and fixed interest-bearing securities issued by the state and central governments.
- The investment objective is to generate returns primarily through investments in sovereign securities issued by the Central Government and/ or a State Government or repos/ reverse repos in such securities or any security unconditionally guaranteed by the Central / State Government.
- As per SEBI norms, gilt funds have the mandate to invest at least 80% investments in the Long-term Government Securities.

Gilt funds in India are of 2 types: -

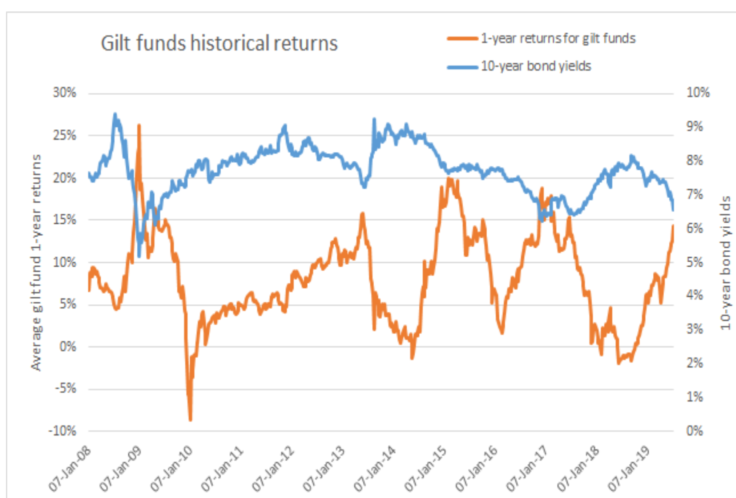
- Gilt funds that invest mostly in government securities across maturities.
- Gilt funds with constant maturity of 10 years – these funds must invest at least 80% of their assets in government securities with a maturity of 10 years.

How do Gilt Funds Work?

- When the Government of India is in need of funds (or loans), it approaches the Reserve Bank of India (RBI). Apart from being the apex bank, the RBI also acts as a banker to the government. The RBI lends money to the government after borrowing from other entities such as insurance companies and banks.
- In exchange for the loan, the RBI issues government securities with fixed tenure, to which the fund manager of a gilt fund subscribes. Upon maturity, this gilt fund returns the government securities and receives money in return. For an investor, gilt funds can be an ideal blend of low risk and reasonable returns. However, the performances are highly dependent on the movement of interest rates. So, a falling interest rate regime would be the best time to invest in gilt funds.

Why are gilt funds in the news?

- In recent times, the RBI has undertaken a series of rate cuts to infuse liquidity into the system.
- The falling interest rates have translated into an appreciation in prices of long-term bonds and G-Secs alike.
- Expectedly, funds that are invested in such securities have benefited.



Why invest in Gilt funds?

Strong Correlation to RBI policy stance:

- Sovereign yields have very high correlation to RBI policy rate and liquidity.
- The economic slowdown is evident not only in India but world over. This has caused all major central bankers of the world including the RBI to flush market with liquidity (in excess of Rs 7 lakh cr).
- The repo and reverse repo rates have been slashed aggressively and brought down by 115 and 155 bps respectively in 2020.
- RBI still maintains a solid dovish stance so as to support growth. This provides a strong growth undercurrent to the Gilt funds and creates an opportunistic window for investor.

Flow of Savings into Gilt

- The living expenditures are going down. Especially the discretionary spends by people/institutions are declining.
- The resultant higher savings will prefer allocation in 'safe' assets vis-à-vis risky assets.

Index Inclusion of India:

- India's inclusion into global debt indices will lead to fundamental change.
- This may allow global funds to allocate to Indian Gilt. Compared to other peers, the macro picture of India is in much better shape and still provides higher real yield.
- Thus, we may see demand surge in Gilt by domestic and overseas investors over period of time.

How Returns on Gilt Funds generated: -

- Fund Managers actively manage the duration to generate performance.
- Fund Managers keep taking spread calls by adding State Development Loans (SDL) when he/she believes the spread between Gilt and SDL has peaked and vice versa.
- Gilt funds are capable of yielding double digit returns. However, with changes in overall interest rates, returns from Gilt Funds are not guaranteed and highly variable. Therefore, investing in Gilt funds would be advantageous if interest rates fall. Gilt funds are still expected to deliver higher returns than even equity funds when the economy as a whole is facing a recession.

Who Should Invest in Gilt Funds?

- Gilt funds only invest in government securities ranging from medium to long-term horizons.
- Gilt Funds are all seasonal products suitable for long term investors. More importantly, Gilt is a strong cover of value when credit risk perception rises. Thus, with portfolio value can be optimized having right asset allocation
- They are not the same as bond funds because the latter may allocate a part of the assets in corporate bonds, which can be risky.
- Gilt Fund is as critical to a debt allocation as Large/midcap/Small cap fund is to equity investment component.

Like any other investment, gilt funds do have their advantages and disadvantages: -

Advantages: -

- Less risky:
  - The bonds and securities issued by the government bear sovereign guarantee, such securities are *completely safe and possess almost zero credit risk*
  - Gilt Funds are pure debt funds, there is no allocation to the Equity component in their portfolio. Thus, there is no Equity Risk which are associated with the stock market vagaries
- Tax Benefits:
  - Investors should note that not only are these returns higher than those offered by traditional investment avenues like bank fixed deposits, but they are also more efficient in terms of tax benefits.
  - Gilt funds are given the same treatment as debt funds and are thus, eligible for the benefit of indexation on capital appreciation.
- Open to retail investors:
  - Not only institutional investors can invest in G- sec market but Gilt funds provide retail investors a low-cost way to invest in G-sec, which otherwise was open only to large players.
- Easiness:
  - Just like stocks or bonds, government securities are traded in both the primary and secondary markets. This means that as a small, individual investor, it is possible to do the buying, selling and trading of securities yourself.

Disadvantages: -

- Interest rate risk:
  - Due to inverse correlation increase in interest rate will lead to falling price of G-sec which is a big risk to the investor.
- Spread risk:
  - The sovereign yield curve might remain constant, investments in corporate bonds are exposed to the risk of spread widening between corporate bonds and gilts.
  - If this spread widens, the prices of the corporate bonds tend to fall and so could the NAV of the Scheme.
- illiquid:
  - Investors have to keep in mind that gilt funds are not as liquid as other debt funds as G-secs are not actively traded for all tenors. Moreover, if there is a sudden redemption pressure, fund houses will have no other means but resort to a distress sale.
  - Also, investors must avoid those gilt funds that have a small corpus because these funds are not able to perform well in case of sudden volatility in interest rates and if there is a sudden redemption pressure.

Taxation on Gilt Funds: -

- There is no securities transaction tax (STT) that applies to the gilt funds.
- They are taxed as any other capital gain by investing in debt instruments under the Income Tax Act, 1961. The rate of taxation is based on your holding period.
- If the investment duration is less than 3year, short-term capital gains (STCG) are clubbed to the total income of an investor and taxed according to his/her income tax slab.
- . If for more than 3 years, the long-term capital gains (LTCG) will be taxed at 20% with indexation benefits.

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