NVESTELITE RESEARCH
Investment Advisor

BOND FUNDS

Dynamic Bond Funds

The dynamic bond schemes, as the name suggests, are dynamic in terms of the composition and maturity profile. The main objective of dynamic bond funds is to provide 'optimal' returns in both rising and falling market scenarios. It majorly depends on the fund manager's decisions and management of the portfolio. These funds generally have huge assets under management (aum), running to a portfolio worth several thousand crores.

Sometimes, there could be a long pause in between interest rate changes. This can take a hit on the income of bond investors. Therefore, these funds are an excellent alternative for those wishing to ride the interest rate cycles. Here, fund managers 'dynamically' trade instruments of different maturity periods as per the anticipated change in rates. For instance, during a falling interest rate scenario, a fund manager increases the holdings in long-term instruments like gilts.

Who can invest in Dynamic Bond Funds?

The dynamic bond funds are ideal for investors who are not experts in making the right calls based on the interest rate movement. Investors with moderate risk appetite and investment horizon of 3-5 years should invest in these funds.

A SIP (Systematic Investment Plan) approach will work as it allows you to combat the volatility. However, one should always remember that the returns in dynamic bond funds depend mostly on the interest rate movement.

Features & Benefits of Dynamic Bonds

1. Role of Asset Manager

The fund manager's view of interest rate is exceptionally crucial. As seen with many funds in early 2017, if RBI takes a step contrary to the expectation of the fund manager, profits could be significantly reduced.

Dynamic Bond Funds

2. Macroeconomic Factors

Factors like oil prices, fiscal deficit, and new government policies could all affect the returns from the dynamic bond funds. One should always stay invested for more extended periods to minimize the short-term risks.

3. Risk Factors

Like every other instrument, the dynamic bond funds are also exposed to certain risks. These funds are better than short-term funds because they are unable to use the duration strategy. However, if the fund manager is unable to reduce the portfolio as required, the previous profits earned could be affected.

4. Tax-Efficiency

Bond fund investors should stay invested for at least three years to receive indexation perks on capital gains. Here, dynamic bonds differ from other debt funds. This is because of a potential shift in the interest cycle that can result in higher tax incidence.

5. Interest

The price of bonds is inversely proportional to the changing interest rate. So, if the interest rate is increasing, then the cost of the bond will decrease and vice versa. As the interest rates continue to fall, the price of the bonds will rally to the extent based on the remaining maturity. The fund manager may also hold some short-term and medium-term corporate bonds that additionally generate interest income.

6. Free from usual Debt Fund Mandate

Generally, all debt funds should adhere to their investment mandate. For example, a short-term bond fund can only invest in short-term securities and vice versa. However, dynamic bond funds need not follow this rule. They can invest in long-term securities for one month even. It all depends on the interest rate movement.

Dynamic Bond Funds

How a Dynamic Bond Fund Works

Dynamic bonds can switch from long-term to mid-term to short-term securities quickly. For instance, if the fund house deems that an interest rate cycle is about to fall, it can increase its portfolio tenure. Similarly, if the asset manager thinks that rates have hit bottom, resulting in more significant risks of capital losses on long-term bonds, it can reduce the portfolio's average maturity in short notice. This way, it can iron out the 'rate-waves' more efficiently.

Fund managers continuously trade the bonds of varying maturity based on their expectation of change in the interest rate. For instance, the manager will buy more short and medium-term instruments while reducing the holdings in gilts. He may also increase holdings of high-rated corporate bonds to ensure higher accrual income. This is one of the most significant differences between a gilt fund and the dynamic bond funds. The gilt fund manager can only change the maturity of the funds while remaining invested only in the gilts.

Here is a List of Dynamic Bond Funds in India

Fund Name	AUM (Cr)	Returns over 1-Year	Returns over 3-Year	Returns over 5-Year
Franklin India Dynamic Accrual Fund – Direct	3,960.08	9%	9%	10%
Aditya Birla Sun Life Dynamic Bond Fund – Direct Plan	3,249.38	10%	6%	9%
ICICI Prudential All Seasons Bond Fund – Direct Plan	2,791.26	11%	9%	11%
IDFC Dynamic Bond Fund – Direct Plan	2,068.34	16%	9%	10%
SBI Dynamic Bond Fund – Direct Plan	1,083.34	15%	9%	10%

Corporate Bond Funds

What is a Corporate Bond?

Corporate bonds are debt securities issued by private and public corporations. Companies issue corporate bonds to raise money for a variety of purposes, such as building a new plant, purchasing equipment, or growing the business. When one buys a corporate bond, one lends money to the "issuer," the company that issued the bond. In exchange, the company promises to return the money, also known as "principal," on the specified maturity date. Until that date, the company usually pays you a stated rate of interest, generally semiannually. While a corporate bond gives an IOU from the company, it does not have an ownership interest in the issuing company, unlike when one purchases the company's equity stock. Who should invest in corporate bonds?

Corporate bonds are an excellent choice for investors looking for a fixed but higher income from a safe option. Corporate bonds are a low-risk investment vehicle when compared to debt funds as it ensures capital protection. If you opt for corporate bond funds that invest in high-quality debt instruments, then it can serve your financial goals better.

Long-term debt funds often tend to become riskier when interest rates fluctuate beyond expectations. As a result, corporate bond funds invest in scripts to combat volatility. They usually go for an investment horizon of one year to four years. This can be an added benefit if you remain invested for up to three years. It can also prove to be more tax-efficient if you fall in the highest income tax slab.

Features & benefits of corporate bond funds

a. Components of corporate bonds

Corporate bond funds invest predominantly in debt papers. Companies issue the debt papers, which include bonds, debentures, commercial papers, and structured obligations. Each of the components carries a unique risk profile and maturity date.

Corporate Bond Funds

b. Price of the bond

Every bond has a price, and it is dynamic. You can buy the same bond at different prices, based on the time you choose to buy. Investors should check how it varies from the par value – it will give information about the market movement.

c. Par Value of the bond

This is the amount the company (bond issuer) gives you when the bond matures. It is the loan principal. In India, a corporate bond's par value is usually Rs 1,000.

d. Coupon (interest)

When you buy a bond, the company will payout interest regularly until you exit the corporate bond or the bond matures. This interest is called the coupon, which is a specific percentage of the par value.

e. Current Yield

The annual returns you make from the bond is called the current yield. For example, if the coupon rate of a bond with Rs 1,000 par value is 20%, then the issuer pays Rs 200 as the interest per year.

f. Yield to Maturity (YTM)

This is the in-house rate of returns of all the cash-flows in the bond, the present bond price, the coupon payments until maturity and the principal. Greater the YTM, higher will be your returns and vice versa.

g. Tax-efficiency

If you are holding your corporate bond fund for less than three years, then you must pay short-term capital gains tax (STCG) based on your tax slab. On the other hand, Section 112 of the Indian Income Tax mandates a 20% tax on long-term capital gains. This applies to those who hold the bond for more than three years.

Corporate Bond Funds

h. Exposure & allocation

Corporate bond funds, sometimes, do take small exposures to government securities as well. But they do so only when no suitable opportunities in the credit space are available. On average, corporate bond funds will have approximately 5.22% allocation to sovereign fixed income.

Risk Factors & Returns

There's always the possibility of bond issuers defaulting on their obligations. This default risk is higher for low-rated securities and goes up exponentially with increasing maturities. If your fund manager invests only in highly-rated companies, expect an average return in the range of 8% to 10%. Here, the risk is also minimal.

On the other hand, if you invest in a slightly low-rated but a well-managed fund, then it can be rewarding. For instance, companies tend to give slightly higher coupon rates to attract investors. However, there is also a chance that the fund manager's call on a company going wrong. Hence, if a company defaults on interest payments or principal repayment or the company gets downgraded further, then it can cause a setback for investors.

Types of corporate bond funds

Broadly, there are two types of corporate bond funds.

Type One: Type one corporate bonds invest in high-rated companies – public sector unit (PSU) companies and banks.

Type Two: Type two corporate bonds invest in slightly lower rated companies such as 'AA-' and below.

Corporate Bond Funds

Let's take a simple example to understand this. Suppose, a CRISIL "A" rated bond with 1-year residual maturity has a 0.56% chance of defaulting and a CRISIL "A" rated bond with a 3-year residual maturity has a 4.79% chance of defaulting. Generally, corporate bond funds allocate at least half their portfolios to bonds with AA rank or lower. So, there's always the risk of some of its portfolio bonds defaulting, resulting in a drag on portfolio returns.

Top Corporate Bond Funds in India

Bond Fund	YTD	1 year	3 years	5 years
Franklin India Corporate Bond Opportunities Fund Direct-Growth	0.95%	8.38%	9.43%	10.2%
Baroda Pioneer Credit Opportunities Fund Plan B Direct-Growth	0.64%	8.70%	10.82%	–
DSP BlackRock Income Opportunities Direct Plan-Growth	0.55%	6.54%	9.11%	9.60%

Tax Free Bonds

Tax-Free Bonds

As the name suggests, tax-free bonds are free from taxes since these allow the government to generate interest income. These come with a fixed rate of interest and the profit made from them are generally invested in infrastructure-related projects.

Tax-free bonds have acquired a lot of popularity these days considering that the interest income earned from these bonds is **free from being taxed**. These bonds are issued by government enterprises and there is hardly a risk of non-payment of interest amount. The tax-free bonds provide fixed rates of interest. The profits from these bonds usually get invested in infrastructure projects.

Tax-free bonds come with a long term maturity period of 10, 15, and 20 years. The major issuers of tax-free bonds in India are Power Finance Corporation, Indian Railway Finance Corporation, and NHAI to name a few.

Benefits of Investing in Tax-Free Bonds

Tax-free bonds come with a lot of attractive benefits. Listed below are the major benefits offered by tax-free bonds:

- Investors can enjoy tax benefits by investing in tax-free bonds. These bonds are 100% tax-free. The interest income received from these bonds is calculated as a part of your total annual income.

- You get higher interest rates on your invested amount. Tax-free bonds provide good returns on your investments.

- Interest is paid on these bonds annually. It gets directly credited in the bank account of the investor.
- Tax-free bonds provide steady returns for longer terms such as 10 and 20 years.

Tax Free Bonds

Tax Saving Bonds vs Tax-Free Bonds

There are a few differences between tax-free bonds and tax saving bonds. The major differences between tax-free bonds and tax savings bonds are:

- In tax-free bonds, the interest income earned from investing in them is free from taxation as per Section 10 of the Indian Income Tax Act, 1961. But, the tax-saving bonds don't offer this benefit. In a tax saving bond, only the initial investment is free from tax.

- Compared to tax saving bonds, tax-free bonds offer slightly higher rates of interest, and any retail investors can invest in tax-free bonds up to Rs.5 lakhs.

- Tax savings bonds are investment instruments for individual investors who get tax exemption on investing a maximum amount of Rs. 20,000 under Section 80CCF of the Indian Income Tax Act. The same is not applicable for tax-free bonds that are free. Given that you can invest a maximum of Rs. 20,000, tax-saving bonds may not serve you as the investment tool for investment. You would not receive regular cash flows by investing in tax saving bonds.

- In tax-free bonds, you need to invest your money for a particular lock-in period. But, in tax saving bonds, you don’t have to do so. The tax saving bonds offer you a buyback clause at the end of each 5 or 7 years which enables you to withdraw your investments. However, tax saving bonds are ideal for those people who have a low-risk appetite.

Tax-Free Bonds in India

In 2015, the government of India has permitted seven state-owned companies to sell tax-free bonds in India for the financial year 2015 to raise an amount of Rs.40, 000. Listed below are the top seven tax-free bonds offered by different companies in 2015:

Tax Free Bonds

STATE OWNED COMPANIES	ALLOCATED AMOUNT OF BONDS
National Highway Authority of India	Rs. 24,000
Indian Railways Finance Corporation	Rs. 6,000
Housing and Urban Development Corporation	Rs. 5,000.
Indian Renewable Energy Development Agency	Rs. 2,000.