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Give your fund manager time to ride out current volatility

If your dynamic bond fund manager is still maintaining a high average maturity despite the recent spike in interest rates, it is because he expects rates to ease

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Currently, dynamic bond funds are displaying wide divergence in their average maturity, in the range of 1.60-13.52 years. With the benchmark 10-year government bond (G-sec) yield having touched a high of 7.19 per cent recently (compared to 6.41 per cent on July 24), one would expect managers of dynamic bond funds to reduce the duration of their funds. But many have chosen not to do so. Experts say that provided they had chosen their fund carefully, investors should trust their fund manager to negotiate this period of volatility.

A variety of factors have contributed to the spike in G-sec rates. "Over the past couple of months, the US Fed has turned more aggressive in its interest rate outlook, driving rates up globally. Inflation in India has run ahead of expectations. Events in Saudi Arabia have driven crude prices up, which feeds into inflation. And finally, credit growth has begun to pick up, and we've already seen State Bank of India hike bulk deposit rates," says Kunal Bajaj, founder and chief executive officer, Clearfunds.com.

Experts differ on why some fund managers have lowered the duration while others have not. One view is that some have simply been quicker to respond to these events than others. The other view is that different fund houses have different strategies for running their funds. "Some funds simply don't raise their average maturity to very high levels. They keep the range between two years on the lower side and eight years on the higher side. Others operate in the two to 20-year range," says Vidya Bala, head of research, Fundsindia.com. The latter have a more high-risk, high-return strategy. Bala says the average maturity for the category as a whole has come down: It stood at over 10 a year ago and has now come down to 7.9 years.

VARYING LEVELS OF DURATION RISK

Fund	AUM (₹cr.)	Average maturity (yrs)	Modified duration (yrs)
Aditya Birla SL Dynamic Bond-Reg(G)	10,983	13.52	6.49
IDFC Dynamic Bond Fund-Reg(G)	4,987	8.75	6.06
SBI Dynamic Bond(G)	3,965	7.2	4.85
Reliance Dynamic Bond(G)	3,774	8.53	5.36
ICICI Pru Long Term Plan(G)	3,674	5.95	3.83

Source: Value Research and Ace MF

YOUR MONEY

Fund managers also hold divergent views about where interest rates are headed next. "Some fund managers believe that the 10-year G-sec, having gone up so much, may ease from its current levels and they may benefit by maintaining a high average maturity," says Bala.

Investors in an aggressive debt fund category like dynamic bond funds do run the risk that their fund's performance could be affected by a sudden spike in interest rates. In 2013, during the taper tantrum, the 10-year bond yield had risen from 7.1 per cent in May to 9.1 per cent in November 2013. But then it fell all the way to 6.4 per cent in July this year.

Experts suggest investors should stay invested in these funds. "So long as your fund is actively managed, treat the dynamic bond category as a long-term asset allocation vehicle in the fixed-income space, and do not allow yourself to be affected by the near-term environment," says Suyash Choudhary, head of fixed income, IDFC Mutual Fund. He cites a couple of reasons why retail investors should not switch in and out of these funds. One, they are likely to receive information with a lag. Two, the tax treatment is more benign if you sell these funds after three years. He adds that if you look up the three-year rolling returns of well-run dynamic bond funds, they have given good returns across interest-rate environments.

Investors should exercise a few precautions. "Of your total debt fund portfolio, not more than 20-25 per cent should be allocated in this aggressive category. Also, have a horizon of three-five years for investments in dynamic funds to allow the fund manager to navigate such volatile periods," says Bajaj. But if you are close to your investment goal, exit these funds and shift your money to a less volatile category such as ultra-short term or liquid fund.