

Interest rates and mutual fund value

In the last few months there has been so much of buzz about debt funds. These mutual funds that invest in fixed income securities issued by banks, government and companies have been in news for their good returns. Investors have also been approached by advisors who tell them that the interest rate cycle has turned and that investments should now be in debt funds. Why should interest rates matter to debt funds?

Debt funds invest in fixed income securities which are issued with a specific tenor, and pay interest at pre-specified intervals. Debt securities are a favourite with investors who like their investments to be stable, earn a regular income and return their principal without loss. If a company issues a bond repayable in 5 years, with an interest rate of 9% per annum, investors are happy subscribers, as long as they know that their principal is not at risk. A debt fund invests in a portfolio of such securities.

What is the difference between a debt fund and debt securities then? A debt fund buys fixed income securities, but does not simply hold them and accrue the interest due on them. It updates what it holds in the portfolio with the current market value of the bonds. Why is this important? Consider for example the 9% 5-year bond we discussed above. Why does this bond pay a 9% interest? Why not 8% or 10%? 9% is the market rate for the borrowing company, when the bond was issued. It is the interest that the issuer and the investor agree as being fair, at that time. After the bond has been issued, it continues to pay 9% per annum. But that is not always the market rate. Assume that few days later, similar bonds are being issued at an interest rate of 8%. Why so? Interest rates have fallen and new borrowers are able to access the market at 8%. The old bond however will continue to pay 9% because that is what was promised until maturity.

Given this change in interest rate situation in the market, what happens to our old bond? It is now more valuable. Investors want to buy the old bond that pays 9%, instead of buying the new bond that pays 8%. What happens to the price of the old bond? It moves up. It is no longer available at Rs.100, its issue price. The price will move up reflecting the fact that interest rates have fallen, making the existing bonds more valuable than the new bonds. This is what happens to the bonds held in a mutual fund portfolio. They will move up in value when interest rates fall. This means the NAV of the debt fund will move up from the gain in the value of the bonds held in the portfolio.

This is why debt funds are a big favourite when interest rates fall. A debt fund, which is the only portfolio that is updated for current market value, generates its returns from two sources: interest income and capital gains from the appreciation in the value of bonds. An investor in a debt instrument will face loss of income from falling interest rates. But an investor in a debt fund will smile from the double bonanza of interest income augmented further by appreciation in the value of the fund.

Debt funds offer a range of products to investors. Investors should choose their debt fund based on their need for income and their ability and willingness to take on the risk of changing NAV.

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