Have debt mutual funds now turned more attractive than bank FDs after RBI hikes?

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With bond yields remaining at elevated levels, experts think a large part of known risks such as inflation concerns are priced in the fixed income markets. Having said that, the upward risks to inflation still remains and hence volatility around expected evolution of yield curve is here to stay, they say.

“Capital markets (debt funds) are currently much better priced as compared to previous 2 years. Infact, capital markets pricing for risk free rate is significantly higher than most Bank FD rates. So, debt funds are expected to provide much better accruals. At same time, given the uncertainty on expected inflation, high fiscal and current account deficit, longer end of curve might continue to remain volatile," said Akhil Mittal, Senior Fund Manager, Tata Mutual Fund.

Generally, debt funds are considered to be less risky, with investors taking comfort in being able to hedge their risks by parking hard-earned money in instruments that provide better returns than bank fixed deposits. However, in the last one year, some debt mutual funds (MFs) have given a mere average return of about 1-3%, resulting in the funds witnessing outflows in the previous few quarters.

"With this view in mind, it would be prudent to invest on shorter duration debt funds as accruals are decent and duration risk is contained. One category that is very well suited for current cycle is floating rate funds. Upward shifting of overnight rates bodes well for floating rate funds. Constituent wise, floating rate bonds may benefit from rate hikes as accruals go up while effective duration remains very low. So high predictability and lower volatility could make floating rate funds as well-suited choice in current times," Mittal of Tata MF added.

Going ahead rate hikes may continue due to higher inflation projections. For this year, predictions say repo may go beyond 5% to pre-pandemic level.

"Long term yields are expected to remain in range of 7.50 to 7.75. Hence, investors should gradually start looking at long duration funds," said Marzban Irani, CIO (Debt), LIC Mutual Fund.

The 50 bps repo rate hike by RBI today was already factored in with 1 year G-sec yield already trading at 6% pre policy, as per experts. The yield curve is quite steep and is likely to continue to flatten going forward.

"The prevailing term spread between the 10 year and 5 year yield is not attractive relative to historical spreads. Hence, for Fixed Income portfolios, we suggest core allocation to the 4-5 year maturity segment in high credit quality, target maturity debt funds which invest in a combination of G-sec, SDL, and AAA-rated instruments," said Nitin Shanbhag, Head of Investment Products, Motilal Oswal Private Wealth.