IDBI mutual

An Investor Education & Awareness Initiative

DEBT FUNDS

An overview

What are debt funds?

Mutual funds offer a wide variety of schemes to invest in. One category among them is called debt funds. Debt funds generate returns by investing in debentures, government bonds, certificate of deposits, treasury bills, commercial papers and such instruments over different time frames. There are various kinds of debt funds depending upon their investment time frame, risk and type of instruments they invest in.

About debt instruments: Before we try to understand debt funds, we need to familiarize ourselves with debt instruments. The term "debt" simply means that money which one party owes another. This borrowing can be for varying periods and by various parties. Debt is therefore classified based on the tenure and type of debtor.

- **Certificates of deposits:** These are short term debt instruments issued by banks to fund their lending business. They are typically issued at a discount to their face value and redeemed at their face value. The difference denotes the interest.
- **Call money:** These are very short term lending and borrowing transactions carried out among banks and other authorized financial institutions.
- **Treasury bills (T-bills):** These are short term borrowings by the government. The borrowing period would be less than a year.
- **Government bonds:** These are longer term debt instruments issued by the government and often called as Gilts as they are free from credit risk (i.e. risk of not repaying the debt).
- **Commercial paper:** These are short term borrowing instruments used by corporates to meet their temporary funding needs.
- **Corporate bonds and debentures:** These are longer term bonds issued by corporates to fund their working capital and capital expenditure needs. Some bonds pay out coupons periodically while others may be issued at a discount to the face value and redeemed at face value, the difference between the two representing interest. These are often referred to as Deep Discount Bonds.
- **Tri-party repo (TREPS):** Tri-party repo is a type of repo contract where a third entity (apart from the borrower and lender), called a Tri-Party Agent, acts as an intermediary between the two parties to the repo to facilitate services like collateral selection, payment and settlement, custody and management during the life of the transaction.
- **Pass-through Certificates (PTC):** These are claims on the future cash inflows of a bank against the loans that it has given out. Since these loans are repaid over time, the bank sells these loans at a lower interest rate through these certificates.

About debt funds

Debt funds are mutual fund schemes that invest in one or more of the above debt instruments. Money pooled from investors is utilized to purchase debt instruments as per the mandate of the scheme. The scheme would receive the coupons (interest receipts) from the bonds and will pass it on to the investor either in the form of dividends or capital appreciation. The coupon receipts will be reflected in the NAV of the scheme and may be paid out as dividends if opted for. If not, the investor will receive it as a capital gain at the time redemption of his units.

Types of debt funds: Just as there are a number of debt instruments, there are a wide variety of debt schemes depending on where they invest and their investment tenure:

- **Liquid funds:** These are funds with a short investment horizon from 1 day up to 91 days. They typically invest in short Debt and money market securities like T-bills, Certificate of deposits, Commercial Papers, Bonds etc. with maturity of up to 91 days only. Liquid Funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods.
- **Ultra Short Term Funds:** These Funds mainly invest in Debt & Money Market instruments with maturities up to 6 months. If you have a financial goal for near future and want to preserve your capital, this fund is for you.
- **Short Term Funds:** These funds invest in corporate securities and bonds of up to 3 years. If you are a risk-averse investor and are content with moderate returns with lower variations, this fund is for you.
- **Gilt Funds:** Gilt Funds are those that invest only in government securities. The tenure would be as per the objective of the scheme. Due to their investment profile, Gilt Funds carry no credit risk but are exposed to interest rate variations, that is, the government bonds' and hence the scheme's valuations would fluctuate with variations in the interest rate of the economy. If you are looking to park your money without worrying of defaults, this fund is for you.
- **Fixed Maturity Plans (FMP):** Most of the debt funds are open ended, which means they are never intended to wind up, that is, they are intended to exist till 'perpetuity'. However, FMPs exist only for specific periods after which they are wound up. Accordingly, they invest in debt securities with tenures that are equivalent to or less than the tenure of existence of the FMP. The securities are bought and held by the Fund till their maturity and not traded during its tenure. This eliminates the interest rate or reinvestment risk. Also as there is no frequent buying and selling of Debt Instruments like other debt schemes. This helps to keep the expense ratio of FMPs lower vis-à-vis other debt funds
- **Dynamic Bond Funds:** These funds invest in entire spectrum of investment grade debt, G-sec and money market instruments with no cap on Maturity or Duration. Hence, these are exposed to both credit risk and interest rate risk. If you are fine with these risks with an objective to earn better returns, this fund is for you.

Tax Efficiency of Debt Funds

There are two ways in which you can realize the returns generated by a debt fund. One is through distribution of dividends and the other is through appreciation in the NAV. The latter is known as capital gains. These gains are also eligible to be indexed. The term 'Indexation' means that the purchase price can be adjusted upward to account for inflation during the investment period and only the net gain after indexation is taxed. So your gain, net of inflation effect only, would be taxed and that too at a concessional rate of 20%.

For example, if you had bought a debt fund in 2015-16 at an NAV of Rs. 11 and sold it in 2019-20 for Rs. 20, your gain is Rs. 9 per unit. However, for taxation purpose, your gain would be worked as below:

Index number in 2019-20 = 289
Index number in 2015-16 = 254
So indexed cost of acquisition of units = 289/254* Rs. 11 = **Rs. 12.52**
Hence the net gain liable to tax = Rs. 20 – Rs. 12.52 = **Rs. 7.48**

Note: Index numbers are released by the Income Tax department every year. There is a debt fund to suit every short term financial need and risk appetite. An ideal investment portfolio must have a judicious mix of Debt and Equity. Talk to your mutual fund distributor today to pick the best one.

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Please consult your mutual fund distributor before investing.

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully.