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Anil Bamboli of HDFC Mutual Fund

Duration play

A timely call on a steady decline in interest rates helped HDFC Mutual Fund's Anil Bamboli reap the gains

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Debt funds are not perceived to be as risky as equity funds. Yet, as the Amtek Auto episode proved, debt investments come with their own set of risks, and it is possible for investors to lose capital if companies default on their debt obligations.

It is not a surprise then that safety first is the mantra of fixed income fund managers at HDFC Mutual Fund, the country's second largest fund house in terms of assets it manages. "It's all about SLR, the need to balance safety with returns," says Anil Bamboli, senior fund manager - fixed income, HDFC Asset Management. HDFC Mutual Fund's definition of SLR: safety, liquidity, then returns.

On the corporate bond front, HDFC Mutual Fund relies on the 4Cs Credit Model before deciding on their debt investment — character, capacity to repay, collateral and covenants. "While the balance sheet matters, it's important to understand the promoters and the top management," says Bamboli.

Covenants are put in place by lenders to protect themselves from borrowers defaulting on their obligations due to financial actions detrimental to themselves or the business.

Interestingly, the fixed income fund managers at HDFC AMC also rely on their peers from the equities team to get the required low-down on the company management. The research done by the equity team comes in handy particularly when the fixed income fund managers want to invest in unique names. "The understanding of the equities team typically range from 10-20 years for different companies which gives us an edge," Bamboli says. What's more, the fixed income team does not rely entirely on the external rating agencies for its investment choices and sees the ratings as just "one of the inputs".

Apart from the 4Cs, diversification is another safety tool used in the investment process. "We have a scoring framework and as the scores fall we reduce allocation to the company. This helps us reduce risk," says Bamboli.

The fund house's Short Term Plan, for example, has a sizeable portion invested in non-AAA rated papers. However, it is well diversified with investments in 99 securities compared to the category average of 60 securities. "We have the most diversified portfolios. Diversification is across individual credits, sectors and business groups which reduces risk and the impact of any unfavourable outcomes," observes Bamboli.

Scheme	Assets (₹ cr)	1-year return (%)
HDFC Short Term Plan	2,983	9.60
HDFC High Interest Dynamic Plan	1,744	10.03
HDFC Short Term Opportunities	6,930	8.66

Corpus (assets) for the three growth schemes is as on June 30, 2016; Source: Morningstar India

On the other end of the spectrum is the HDFC High Interest Dynamic Plan, which has more than 80 per cent of its portfolio invested in government paper. HDFC Mutual Fund's team has been bullish on interest rate cycle over the last few years. "For the last two years we were of the view that interest rates would fall and the best way to play that would be through government securities," says Bamboli.

While HDFC AMC has been conservative on credit quality, it seems to have been a lot more aggressive on interest rate calls.

"Our broad outlook in the last two years was that inflation will fall and interest rates will be cut. And wherever possible we have tried to increase the duration," says Bamboli. The average maturity period for HDFC High Interest Dynamic Plan has been around 16 years and the fund increased its maturity period between November 2015 and February this year. "This was a period when investors thought that the rate cuts were over and started selling long duration bonds. But we increased the duration and that helped us. In fact, we maximised the duration even in our short term funds (HDFC Short Term Plan and HDFC Short Term Opportunities)."

Industry data show that as a category, short-term gilt, medium-term gilt and long-term gilt funds were the top debt category performers between July 1, 2015 and June 30, 2016, with returns of 10.1 per cent and 9.7 per cent, respectively. Yields of 10-year government papers fell to 7.45 per cent from 7.86 per cent during the period.

While he beat his peers over the last year, the journey over the last few years has not been entirely smooth, admits Bamboli. His interest rate call didn't quite work out in the latter half of 2013 and 2014, a period when the apex bank increased rates by 75 basis points between September 2013 and January 2014, and started cutting rates only in 2015.

While the High Interest Dynamic Plan benefited from declining interest rates, HDFC Short Term Opportunities — with an average maturity of between 1.7 and 2 years — has benefited from the Reserve Bank of India's (RBI) open market operations to infuse liquidity since January 2016. "That has helped the short end of the curve to rally. The curve has slightly steepened compared to two years ago when it was flat," says Bamboli.

A steep yield curve is a variation of the normal yield curve, wherein the interest rates paid on securities with shorter maturities is lower than rates paid on debt with longer maturities.

Bamboli is still bullish and expects repo rate to fall by at least 50 basis points in the next six to 12 months. Inflation seems to be under control at least for the near term although the Seventh Pay Commission and Goods and Services Tax may lead to a spike in headline numbers, he says. "I don't think a 25 basis point hike in interest rates (going ahead) by the Federal Reserve will impact RBI's stance. However, a surge in oil prices can pose a risk."

He is also bullish on India's growth prospects over the medium term and expects credit ratings to improve going forward.