VENTURING INTO THE DEEP

Credit funds chase 8.5% yields in risk-heavy seas

Money managers set sail with lower-rated papers in a rising corporate tide

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Most credit risk debt mutual fund (MF) schemes and some medium-duration funds are likely to deliver over 8.5 per cent annualised returns in the coming years as fund managers increase exposure to lower-rated papers in these categories.

At the end of April, the average yield-to-maturity (YTM) stood at 8.4 per cent for credit risk funds and 7.9 per cent for medium-duration funds.

Data from PRIME Database shows that MF exposure to AA and below-rated papers has risen from ₹45,641 crore at the end of December 2023 to ₹51,360 crore in April 2024. This increase has occurred despite investors pulling out nearly ₹1,350 crore from credit risk funds in 2024 so far.

"Our credit risk fund aims to generate returns by focusing on accrual; therefore, AA and below-rated papers form the core of the portfolio as they offer relatively higher carry," said Akhil Kakkar, senior fund manager at ICICI Pru Asset Management Company (AMC).

"We follow a top-down macro approach in determining our credit allocations across portfolios," said Devang Shah, head of fixed income at Axis MF. While most medium-to-long-term debt funds have struggled to garner inflows in the three to four years owing to unattractive yields and a change in taxation last year, credit risk funds took the biggest hit in the aftermath of the Franklin Templeton MF crisis.

The lack of liquidity in the lower-rated debt market during the initial phase of Covid-19 also forced fund managers to take lower risks in credit risk funds, leading to a decline in their YTM differential vis-à-vis other debt funds.

According to Securities and Exchange Board of India regulations, credit risk funds must maintain a minimum 65 per cent exposure to AA and below-rated papers. Medium-duration funds are bound only by a duration mandate and must maintain a Macaulay duration of three to four years.

Deepak Agrawal, chief investment officer for debt at Kotak Mahindra AMC, said the elevated yields-to-maturity of medium-duration funds are partly due to considerable exposure to AA and below-rated papers.

"The bond index inclusion also adds to the attractiveness of longer-dated government bonds. There is a bias to run schemes with a duration close to the higher end of the mandate," he said.