How to rebalance your fixed income portfolio in current rate scenario?

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Over the last one year, many investors have experienced negative to marginal positive returns on their fixed income holdings. This has come as a not-so-pleasant surprise and they are wondering on how to manage the debt holdings going forward. While evaluating/rebalancing fixed income holdings, it is important to understand the RBI's view, structural shift of interest rate cycle and accordingly formulate the investment strategy.
RBI's policy rate stance:

In its latest annual report, RBI has reiterated concerns over rising inflationary pressures by highlighting following risks: a) Increase in crude oil prices having direct implications for domestic inflation, b) Uncertainty surrounding increase in Minimum Support Price, c) Staggered impact of HRA increases by various state governments, d) Uptick in domestic growth momentum leading to demand side pressures and e) Uncertainty and volatility in the global financial markets.

With reference to inflation projections, RBI expects headline inflation at 4.6% for Q2:2018-19; 4.8% in H2 and 5.0% in Q1:2019-20. As per the report, "the conduct of monetary policy will continue to be guided by the objective of achieving the medium-term target for CPI inflation of 4 per cent within a tolerance band of +/- 2 per cent, while supporting growth". Hence, managing inflation continues to be a key objective & concern for RBI.

Market/economists' readings

Given the rate hikes and recent commentary from RBI, economists are divided on possibility of another rate hike. Few economists believe that RBI's hawkish tone indicates at-least one more rate hike in the near offering. However, there are also economist who believe the rates hike have been front-loaded and see no more rate hike at least for the financial year 2018-19.

Structural shift of interest rate cycle

Irrespective whether RBI opts for another rate hike or prolonged pause, investors need to re-evaluate their fixed income holdings in light of an upward biased yield curve. It appears that we are currently in a midst of a structurally rising interest rate regime. Having a magnified view of 10-Year government bond performance from Jan 2017 till YTD 2018 highlights the upward movement in rates.

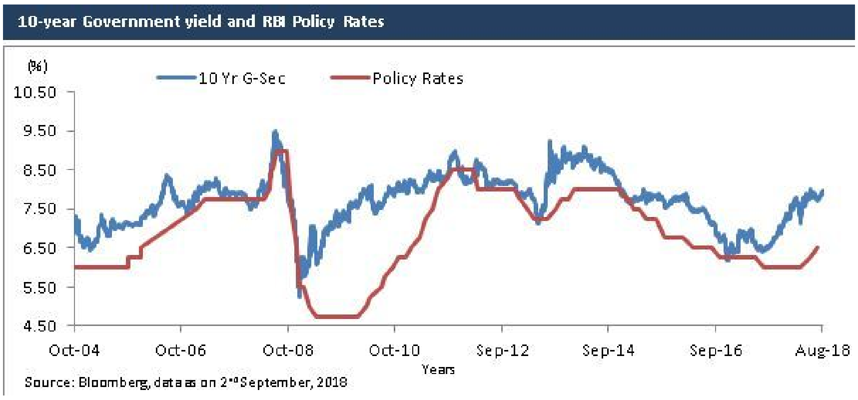
In addition to 10-year G-sec yields, 1 year performance of select CRISIL benchmark indices highlights the adverse impact of increasing 10-year G-sec yields on the fixed income portfolios.

Crisil Indices	1 year Returns (As on 31st Aug'18)
Short Term Bond Fund	4.6%
Long Term Debt	-0.6%

Source: Crisil.com

Clearly, investors holding long duration bonds have suffered much more vis-à-vis investors holding short duration bonds.

A slightly longer view of the benchmark 10-year government bond yield movement overlaid with RBI policy rates clearly demonstrates that their movements have been largely in sync over many rate hike/cut cycles.



What should be the investment strategy

When interest rates are expected to rise, bond prices tend to fall (inverse), resulting in fall in the NAVs of bond funds. Long duration bonds/funds are relatively more price sensitive than short duration bonds/funds to interest rate changes and may see price a steeper price correction in an increasing interest rate scenario. Hence, it is important for investors to prefer low duration and ultra-short term bonds over long duration funds. This strategy will minimize interest rate risk and volatility.

Incase investors are not at all comfortable with any intermittent volatility and prefer locking in yields, we recommend investing in FMPs and interval Plans in a phased manner. However, it is important to note that these are held to maturity instruments and may not provide any liquidity during the holding period.

Also, it is important to note that, while aim is to maximize the yield of the portfolio, investors do take good care on the credit quality that the portfolio brings. Many a times, a marginal improvement in the yield of the portfolios may not be worth for taking undue credit quality risk it entails.

(Ankur Maheshwari is CEO of Equirus Wealth Management. Views are his own)