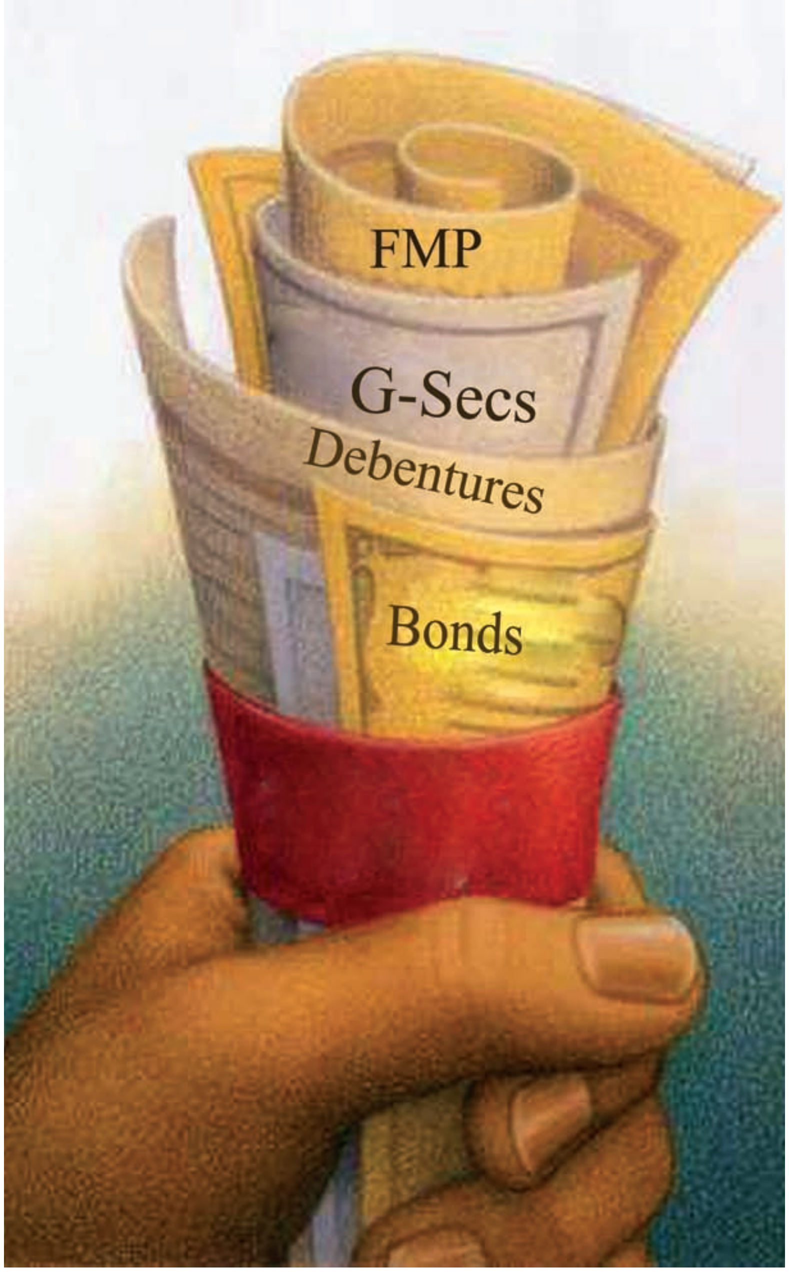
SAFE AND STABLE

Investing in debt instruments not only adds balance to a portfolio but it also provides the much needed assurance of return. However, investing and trading in debt market is not 100 per cent risk-free. A report by Sunil Kumar Singh



Are you tired of tracking the ups and downs of the stock market and are looking for an investment avenue that could give you a stable and assured return? The debt market could be one of the solutions where you can park your hard-earned money.

But what exactly is a debt market and how it functions? How can you, as a retail investor, enter into it, park your money and earn a decent return over a period of time?

Wide gamut of instruments

Debt market is one of the two critical components of the overall capital market, the other being the equities market. However, debt instruments are possibly the most common and popular investment instruments. If you've been investing in any instrument apart from stock market, chances are that you must have bought at least one or two debt products. This is because the debt market is vast and comprises a vast gamut of products ranging from traditional instrument such as a post office PPF to unconventional products like non-convertible debentures, commercial papers, certificates of deposit, etc that are issued by the central or state governments, PSUs, banks, corporate bodies, etc.

Even your post office NSC, post office monthly income scheme (MIS), post office time deposit, senior citizens savings scheme, bank fixed deposit, recurring deposits, Employee Provident Fund (EPF) and traditional insurance plans (such as money-back and endowment) are debt instruments.

Another feature of debt market is that it is not a place to generate quick return, unlike stock market. This is largely because debt market is basically comprised of fixed income instruments of various types like bonds, debentures, government securities (G-Secs) etc.

That's why debt market is also referred to as a 'fixed income market' because, as the name suggests, these instruments pay fixed returns or where return is known is advance.

Types of debt instruments

Broadly, debt instruments can be categorized into three classes: money market instruments, fixed income instruments (like FMP, bonds, G-Secs, debt mutual funds, PPF, NSC, post office MIS) and variable income instruments (like MIP).

While debt market is also termed as fixed income market, not all debt instruments fall in the fixed income instrument category. For instance, even if an MIP is a debt mutual fund it doesn't fall under fixed income instrument category simply because it has got equity exposure.

Let's analyze each type of debt instrument in detail to understand the intricacies better.

G-Secs: A short form of government securities, G-Secs or gilts market is the oldest and the largest constituent of India's debt market in terms of market capitalization and trading volumes. According to statistics by the Bombay Stock Exchange (BSE), G-Secs account for 70-75 per cent of the outstanding value of issued securities and 90-95 per cent of the trading volumes in the Indian debt market.

G-Secs can be a good investment instrument for those retail investors who want a balanced portfolio. G-Secs are issued by the RBI on behalf of the central government or the state governments and normally have a maturity period from 1 year to 30 years. G-Secs pay a fixed interest rate at regular interval of six months, and the principal amount after maturity.

Normally, G-Secs are auctioned by RBI to big institutional players. After the gilts are issued, they are listed on stock exchanges for trading. Most of the trading in the gilts takes place on the wholesale basis in the inter-bank market. The major market participants are banks and financial institutions, mutual funds, insurance companies, primary dealers, provident funds, trusts and individuals. Retail investors can also buy G-Secs from a registered broker, like equities and derivatives, but one needs to have a demat account to trade in them. G-Secs have a face value of Rs 100 and an investor can place order for a minimum of 10 units.

However, retail investors' participation in G-Sec and the overall retail debt market has been very low in India. One reason is that retail debt market was recently opened. It was only in 2003 that NSE had introduced a trading facility through which retail investors could buy and sell government securities from different locations in the country through registered NSE brokers.

Very recently, in order to promote retail investors participation, IDBI Bank in March this year launched the country's first online G-Sec portal 'Samriddi' to enable retailers to purchase government bonds and securities for high yield. A retailer can log on to the portal and register with it for online purchase of government bonds and securities for high annualized yield.

However, despite these efforts investor participation remains subdued in retail debt market. Experts say access to retail debt market for an investor is not as easy as in stock market because of tough eligibility norms. For instance, to trade through IDBI's online G-Sec portal, the minimum amount to invest is Rs 10,000.

Further, as Jitendra P.S. Solanki, Certified Financial Planner & Founder, JS Financial Advisors, Delhi says, the minimum capital required to directly trade in G-Secs through BSE or NSE is very high and it majorly caters to HNIs and not small investors.

Another reason for low popularity of G-Secs and retail debt

How trading is done in retail debt market

Trades in retail debt market are settled in the same manner as in the case of equities on a T+2 (working days) rolling basis. In the case of a buy trade, the investor is required to make payment to the NSE broker so that the amount paid is realized well before the pay-in day, and the securities are then credited by the NSE broker to the client's account after the pay-out.

Similarly, in case of sell trade the client has to give delivery out instructions to the NSE broker well before the prescribed settlement day immediately upon getting the contract note for sale, and the NSE broker would make payment to the client after the pay-out.

Like in case of the equities market, the investor is not affected in case the delivering broker fails to meet its obligation, since NSCCL provides financial guarantee for the net settlement obligation through the Settlement Guarantee Fund separately set up for this purpose.

Difference between NCD and bank FD

Parameters	NCD	Bank FD
Tenure	3-5 years	1-5 years
Safety	Secured rated paper 'AA' with cover on the assets of the company	Unsecured with no charge on the assets of the company. Up to 1 Lakh is guaranteed if there's default.
Yield/ interest rate	12.75 per cent, normally	9-10.5 per cent
Credit ratings	'AA' by credit ratings agencies	Unrated
Tax deducted at source	No	Yes
Liquidity	Listed on stick exchange and can be exited anytime	Option of premature withdrawal but with penalty of 1-2 per cent

Benefits of investing in debt instruments

Fixed income securities help in preserve and increase invested capital and also ensure the receipt of regular interest income

G-Secs are sovereign instruments and therefore they are one of the best investment options for a retail investor as they provide risk free return.

Prices of debt instruments display a lower average volatility as compared to the prices of other financial securities

Debt securities enable wide-based and efficient portfolio diversification and thus assist in portfolio risk-mitigation

Almost all debt instruments have a rating given to them by a rating agency enabling investors to choose according to the degree of risk and corresponding returns

instruments is their complex nature. As Solanki says, “Debt market has been most difficult to understand even by advisors, which has made retail investors stay away from investing in this segment.”

Corporate debt instruments: While G-Secs are issued by RBI to meet borrowing needs of the government, companies (both private and PSUs) also issue debt instruments when they need to borrow money to grow and expand their business. These instruments are non-convertible debt securities, which include mainly debentures and bonds. The basic difference between bonds and debentures is that while the former is secured by assets, the latter is an unsecured loan of a company.

Once issued, a retail investor can buy corporate bonds or subscribe to non-convertible debentures (NCD) through any distribution houses like banks, investment agent or a dealer. Bonds or NCDs, generally have a maturity period of up to 15 years.

After issuance, a bond is listed on either BSE or NSE and can be traded on the open market just like a stock. This means its capital value will fluctuate with demand, just like a stock.

However, what makes corporate debt instruments different from a stock and also an attractive investment option is the interesting but inverse relationship between interest rate and bond price. The value or price of corporate bonds rises when interest rates fall. The

Risk-return matrix

Instruments	Liquidity	Safety	Return
Company deposits	Nil	Low to medium	Maximum 10 per cent subject to rating
Post office MIS/NSC	Low	High	8.4 per cent per annum
PPF	Nil	High	8.6 per cent p.a.
RBI Relief Bonds	Low	High	8 per cent
Tax-free bonds	Nil	High	6.5 per cent
Bank deposits	Medium to high	Medium to high	9-10.5 per cent
Government securities	High	Highest	8 per cent

reverse is also true, that is the price of the bond falls when interest rates harden. This means if you have bought a bond, hold it for a year while interest rates are rising and then sell it, you could earn profit.

Money market instruments: Money market instruments are a subsection of the fixed income market and are short-term debt securities (maturing in less than one year). These instruments include Commercial Papers, Certificate of Deposit, Treasury Bills (T-Bills), etc that are issued by banks or financial institutions. However, money market instruments are traded in very high denominations and are not for retail investors. Nevertheless, for retail investors the easiest way to invest in money market is through money market mutual funds.

Debt mutual funds: Debt mutual funds are the easiest way to get into the debt market. Mutual funds have various schemes in the debt category which retail investors can consider as per their time horizon and risk appetite.

As Solanki points out, "For short-term requirement money market funds primarily known as ultra short term funds and short term debt funds are available. For medium term horizon, fixed maturity plans (FMPs) with low risk and bond funds which carry a little higher risk are there. With some higher risk appetite Monthly Income Plans (MIPs) are also considerable for medium term. If retail investors want to go long then income funds or gilt funds can be chosen based on risk tolerance of an individual."

Adds Sanjay Matai, promoter and owner, The Wealth Architects, Pune, "The debt market for listed debt (both corporate and gilts) is not as developed as the equity market. Given the high transaction amounts involved and poor liquidity, a retail investor would be better off investing in listed debt through appropriate debt MFs."

Inherent risks

Although debt market is considered a safer instrument than equities market, there are certain inherent risks that retail investors need to be mindful of.

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Experts therefore advise that there are a few essential factors a retail investor needs to consider when investing in debt instruments like bonds, gilts, etc.

"Returns, of course, is the most common aspect that a retail investor is normally concerned with. However, it would be advisable to also consider safety, liquidity and taxation before making any investment decisions," maintains Matai of The Wealth Architects, Pune.

He says default risk is one of the biggest risks of investing in debt products. Therefore, it is prudent to preferably invest in top-rated products rather than chasing a few extra percentage returns in companies with weak fundamentals/dubious track record.

He further adds that listed debt/gilts (either directly or through mutual funds) are prone to interest rate risk, if not held till maturity.

"If interest rates go up, prices of bonds/gilts go down and vice versa. So if you sell before maturity you could have capital appreciation/depreciation depending on the interest rate trends," he cautions.

While investing in bonds, a crucial factor to look for is the rating assigned to it, say experts. A bond rated 'BB' or below (on Standard & Poor's credit rating scale and Ba in case of Moody's) means it has high default risk and is termed junk bond. Generally, if a bond's credit rating is raised, its market price tends to rise and its yield will fall. Conversely, if a bond's credit rating drops, the market price will fall so the yield will rise.

Bond yield is basically the annual return on a bond expressed as a percentage of its current market value and is an important guide to be able to compare returns with those on other investments. The market price and yields on G-Secs can be followed each day on RBI's website and some major financial newspapers.

Time horizon and risk tolerance

Other important factors to consider for any investor in debt market are time horizon and risk tolerance, point out experts.

As Solanki points out, "Money market funds and short term funds have lower risk and are appropriate for short term horizon, generally 6 months to a year. Contrary to this, income and gilt funds have higher risk but are appropriate for long term horizon i.e. 2-3 years. Similarly FMPs have lowest risk when held to maturity and is suitable for a fixed return while MIPs for same horizon have higher volatility."

He adds that what instrument you choose will depend on when you need the funds and how comfortable you are seeing your investments volatile. If you have only a year then gilt funds do not make sense while for long term, say 3-4 years, money market funds may not produce the desired returns. The tax structure of debt funds also leads to higher returns when compared to other similar instruments.

He further adds that when it is said that fixed income products are risk free, it does not mean that they carry no risk. The risks which need to be kept in mind are interest rate risk, liquidity risk, inflation risk and credit default risk.