**Fixed income funds**

There are multiple categories of funds in Mutual Funds, which have been defined by SEBI.

One fundamental difference between equity and fixed-income funds is in the latter, you can ladder or structure.mar There are funds available for all investment horizons. In equity, all funds require long investment horizon.

Here are the basic concepts. Any fund can broadly be categorised as either open-ended or close-ended. Open-ended funds are ones which you purchase from the AMC — the Asset Management Company constituted by the Mutual Fund. When you require money, you redeem (sell back) with the AMC. Hence the corpus size of the fund changes every day.

In close-ended funds, you cannot buy or redeem with the AMC and the corpus size does not change, from this perspective. The funds are listed on the exchanges (NSE/BSE) for investors to trade. Market-price changes impact the size of open and close ended funds as NAV is computed at market prices.

The other important concept is of ‘accrual’ in fixed income funds. Instruments in such funds have a known interest rate. For daily NAV computation, proportionate interest for a day is added to the NAV. There is a change in market price every day and the NAV is computed as per price level of the day. That adds to (when prices rise) or takes away from (when prices slide) the accrual in the funds. The impact of market-price movement is called mark-to-market, as the NAV computation happens at prices marked to the day’s market.

In fixed-income funds, most returns come from accrual and a small component from mark-to-market gains. This is due to the nature of bonds; there is a defined maturity value, which is usually the bond’s face value and a defined maturity date.

Market price can rise only so much as on maturity it is the face value that is going to flow back. In equity funds, most returns come from price rise, as dividend yield viz. dividend paid divided by the stock’s market price, is on the lower side. In fixed-income funds, there are 16 open-ended categories. Plus, there are close-ended funds like Fixed Maturity Plans (FMPs) and one useful category called Target Maturity Funds (TMFs), which may be either be open or close ended. Of the 16 open-ended fixed-income fund categories, the important ones are:

Liquid Fund: SEBI’s definition is the fund will invest in instruments with residual maturity of up to three months. Given the the portfolio maturity is very low, less than three months, mark-to-market volatility is very low. The funds earn mostly from accruals. As it is a very defensive category, you can keep the emergency cash-equivalent component of the portfolio in Liquid Funds. Minimum investment horizon is one to two weeks.

Money Market Fund: These funds invest in instruments with a maturity of up to one year. This is a relatively-defensive fund; mark-to-market has limited impact on returns and accrual plays a major role. You require an investment horizon of a few months.

Banking and PSU Fund: As much as 80% or more of this fund must be invested in instruments issued by banks, PSUs. Portfolio maturity is not defined. A horizon of 3 years should be enough depending on fund maturity.

Corporate Bond Fund: The definition is 80% or more of the fund should be invested in instruments of highest credit rating. Fund portfolio maturity is not defined and AMCs usually run a portfolio maturity of three to five years. Depending on the portfolio maturity, horizon of three years should be adequate.

Dynamic Bond Fund: The fund manager can modulate the portfolio maturity, from high (say 10 years) to low (say four years) as per market view. You need, say, a five-year horizon as the fund faces market cycles of varying mark-to-market impact.

Gilt Fund:These funds invest in government bonds, minimum 80% as per regulation. These have long maturity and you need a long horizon, say 10 years. Market goes through cycles, and this category has a relatively higher impact of mark-to-market.

Target Maturity Fund: There is defined maturity, which could be, say, three years or seven years, from launch date. In the initial portfolio construct, the bond maturity in the portfolio is same as the maturity of the fund. Upon maturity, the fund ceases to exist and money flows back to investors. Over the course of the fund, the balance maturity rolls down. There are TMFs of various maturities. The credit quality is usually of the highest grade. Till you hold TMF till maturity, you have high visibility on the returns.

Conclusion

You can check the portfolio maturity of funds in the monthly factsheet. Decide on your cash-flow horizon and pick funds of appropriate maturity.

There is a possibility of interest rates coming down sometime this year, hence, this is the time to invest in fixed-income funds.