PPFAS MUTUAL FUND
There's only one right way©

A note from Rajeev Thakkar

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Note on the Parag Parikh Conservative Hybrid Fund (PPCHF)

When we announced the launch of PPCHF, it was a head scratcher for many. We had earlier announced that we would be launching a scheme in the debt space. This was instead a launch in the hybrid category.

Typically, Debt Fund are either segmented by the issuer

- Corporate Bond Fund
- Banking and PSU Fund
- Gilt Fund

Or on the basis of maturity

- Ultra Short Duration Fund
- Short Duration Fund
- Medium Duration Fund
- Long Duration Fund

And so on.

Even in the hybrid fund category of funds, this particular class of funds has been more or less dormant, the more popular classes being Balanced / Aggressive Hybrid Funds and Balanced Advantage Funds or Dynamic Funds.

At the time of the NFO, we tried to explain the broad contours of the scheme. However in the absence of an actual portfolio, we were largely saying what was there in the offer document. Now that we are disclosing the scheme portfolio in the first fact sheet since the launch of the scheme, it is a good opportunity to explain our thinking further.

Suitability

At the time of the fund launch itself, we have been saying that the scheme is not suitable for short term fund deployment. It is suitable for medium to long term fund deployment.

Interest Rate environment

An individual investor today can invest in Bank Fixed Deposits or Small Savings Schemes. Some of the interest rates are given below.

@State Bank of India offers 5.3% (5.8% for senior citizens) interest on 3 to 5 year deposits and 5.4% on 5 years and above maturity (6.2% for senior citizens).

National Savings Certificates for a 5 year tenure offer an interest rate of 6.8% p.a. As such these are great investment avenues, the only drawbacks of something like a National Savings Certificate are that liquidity is not easily available, regular cash flows are not there and they are tax inefficient.

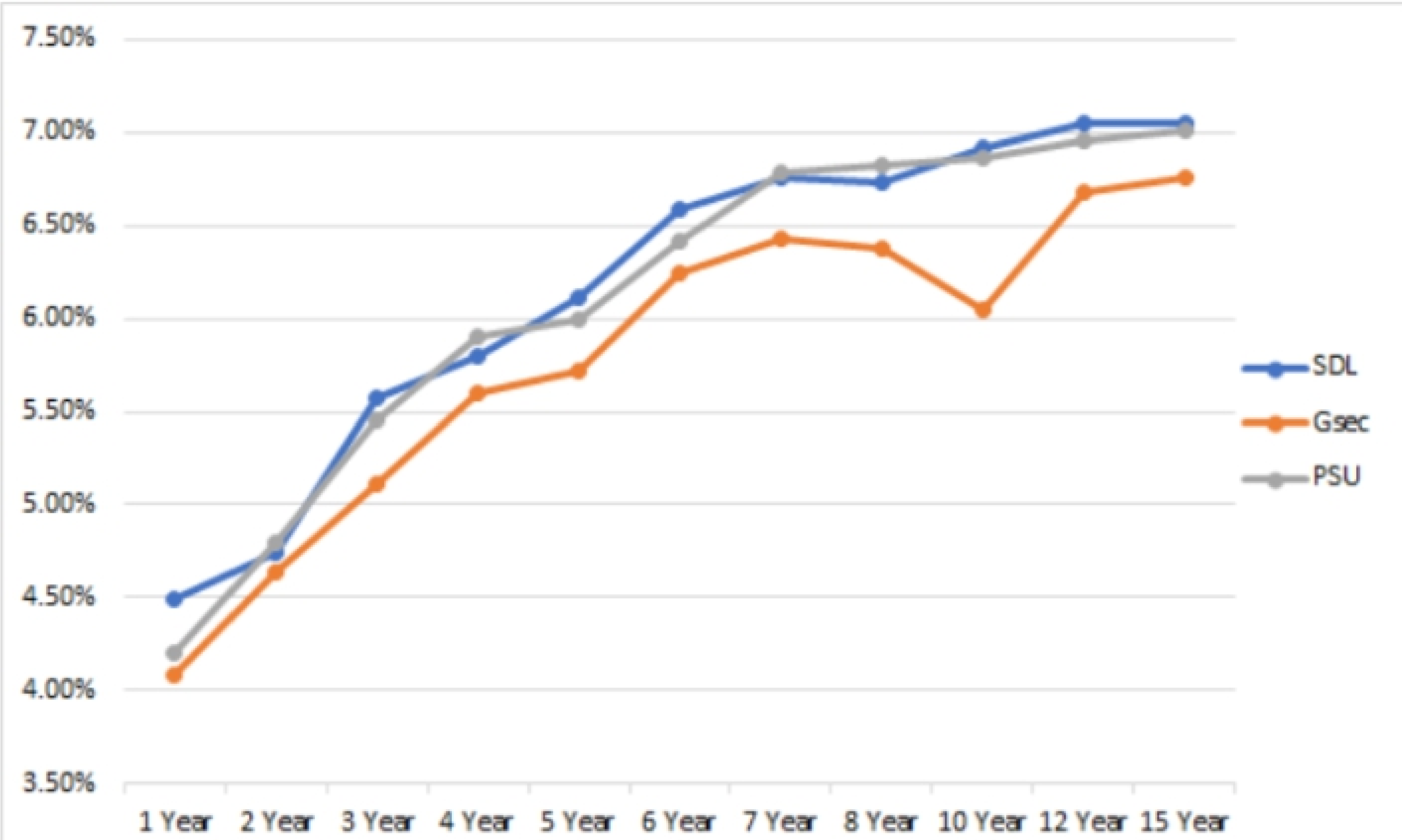
These interest rates are important to keep in mind, especially for the later discussion on interest rate risks.

@Source-SBI Website

Why does it not make sense to pre-define the issuer?

In the equity space, we have chosen to be in the Flexi Cap segment. The thinking is that we should choose the capitalisation space where the opportunities are attractive rather than having three predetermined categories of large cap, mid cap and small cap funds.

A similar thinking is behind PPCHF where we are not segmenting our fund into Gilt, Banking and PSU and Corporate Bond Funds. The following traded yields in the debt markets on June 30, 2021 will make the situation very clear.



Based on the above, in the current market, we see the Sovereign State Development Loans as the most attractive space. These are backed by the taxing power of the government and indirectly the monetisation power of the Reserve Bank of India. In the current environment, we would not want to invest in corporate bonds at yields which are lower than sovereign paper. At some other point in time if quality AAA or AA+ corporate papers are paying a decent spread over sovereign paper, we may choose to invest in them. The lone AAA bond in our portfolio is one where there is an attractive yield pick up available over sovereign bonds. Wherever we choose to invest in non sovereign paper, we will keep individual exposure to issuers limited rather than buy huge chunks of individual paper.

Central Government Securities, as can be seen from the yield curve, trade at significantly lower yields than State Government Securities and AAA Bonds. The advantage of Central Government Securities is that they trade in huge volumes and to the extent it is expected that one may need to liquidate some holdings, they are very liquid. It is not that State Government Loans and AAA bonds are not liquid. It is just that in comparison to Central Government Securities, the volumes are lower and the bid / offer rates are wider. Hence the impact cost on the buy / sell price may be a bit larger if a huge volume is to be transacted.

(A special class of Central Government Securities are the recently issued bonds in popular maturity categories. For example a 10 year Central Government Security recently issued. These are the most liquid and offer the lowest yield in comparison to similar other securities. The big dip around the 9-10 year maturity mark that you see in the Central Government Yield curve is on account of the security 5.85% GS 2030. These are in market terminology called on the run securities).

Ok, at least specify the maturity / duration ….

There is some merit in specifying the maturity duration, especially at the short end. If you have a goal to buy a car in say 2 years, a fixed deposit or a short duration fund or a Fixed Maturity Plan would be ideally suited and PPCHF would not be appropriate.

PPCHF is suited for debt investments which are of the following types

- Regular savings as part of a financial plan in the debt segment with a longer term time horizon.
- People (including retirees) who are looking at generating periodic cash flow from their investments. The investment horizon can be typically long (a retiree at the age 60 may spend 10 - 30 years in retirement) but there is a need for liquidity in case of an unforeseen event like a medical need.

A minimum investment horizon of 3 years+ is recommended for this scheme.
As can be seen from the portfolio, currently the investments are largely in the 6 to 7 year maturity bucket. PPCHF does not aim to be investing and moving between extreme ends of the maturity spectrum, say invest in short term treasury bills at some time and at other times invest in 30 year bonds.

However flexibility in selecting the maturity bucket helps us invest where we see the yields attractive.
Currently the SDLs in the 6-7 year maturity bucket capture most of the steepness of the yield curve.
Hence for example these are trading at Yield To Maturity of around 6.6% as compared to short term treasury bills of 3.3%. Lengthening of the maturity beyond this point does not add much by way of yield but increases the interest rate risk (risk of locking up funds at yields which may possibly be higher in future years).

The Annualised Yield To Maturity (YTM) on the debt portion of the PPCHF is 6.72% and the Modified Duration of the debt portion is 4.89 years.

OK, Why not a Dynamic Bond Fund?

We did consider this category and it has its merits. However when we compared this with a Conservative Hybrid Fund category, we found that we could have the additional opportunity to invest in REITS / INVITS in the Conservative Hybrid Fund category. Even the minimum 10% of the allocation toward equity investments can be managed with a conservative investor in mind. We can also have arbitrage strategies, special situations and so on in the equity allocation.

REITs, INVITs and Equity shares apart from offering periodic payouts also have the possibility of growth in the payouts and capital appreciation over time.

The yields on the REITS and Equity Shares as on June 30, 2021 are given below.

(Please note that the payouts on REITS and Equities are not fixed and can vary based on business and other considerations)

REITS:	
Brookfield India REIT*	8.0%
Embassy Office Parks REIT	6.1%
Mindspace Business Parks REIT	6.8%

* Expected yield based on the 6 month guidance from the managers of the REIT. Brookfield has recently got listed and is yet to make its first payout.

Equity Shares:	
ITC	5.3%
Bajaj Auto	3.3%
Petronet LNG	5.1%
Coal India	8.5%
Power Grid Corporation of India	4.3%

What about the interest rate rate risk?

Interest rate risk is in my opinion slightly less understood by investors as compared to say credit risk. Credit risk is relatively simpler to understand. Someone who borrowed from you did not pay back at all or paid only part of the dues. Or the Issuer was downgraded by the Credit Rating agencies.

To explain interest rate risk, let us get back to National Savings Certificates (these are not traded and cannot be sold or purchased, the following is only for the purpose of illustrating the concept of interest rate risk).

If you invest Rs. 1,000 in a National Savings Certificate (NSC), you get Rs. 1,389 after 5 years. An interest rate of 6.80% per annum is available. Now let us say the government increases the interest rates on National Savings Certificates to 7.05% per annum immediately after you invested at 6.80% per annum. You are not eligible for the higher interest rate since you have invested at the old rate.

Would you now get a buyer for your older NSC at Rs. 1,000 after the rate increase has been announced? The answer is no since newer NSCs are available at higher interest rates. For a buyer to buy your older NSC, you would have to sell them at Rs. 988.20 to effectively give the buyer the new interest rate of 7.05% per annum.

Do note however that if you hold the NSCs till maturity, you do not have to worry about the interest rate movements and you will still get Rs. 1,389 on maturity (that is if you do not envy your neighbour who got higher interest rates).

In simple terms, interest rate risk matters if your investment horizon does not match the maturity profile of the investments, especially if you need money in a short time while the bonds are of a longer maturity.

In a mutual fund of course there is no one to one correspondence between the maturity preference of an individual investor and of the fund except for schemes like Fixed Maturity Plans. Open end mutual funds do not have a fixed maturity date and they may or may not hold bonds to maturity. There will also be fresh inflows and outflows and newer investments and sales.

However, as long as the investor broadly has time horizons which are not too different from the fund investments, things should work out fine over the tenure of the investment on the interest rate risk front.

The other thing to note is that while interest rate movements do affect bond prices, the bond price movements are typically far less volatile than the movements of equity shares. When we say that mutual fund investments are subject to market risks, it means very different things in the context of equity funds vs debt oriented funds.

“Interest Rate Kya Lagta Hai?” (What do you think of the interest rates?)

Interest rate kya lagta hai? Is the debt market equivalent to the question, “Market kya lagta hai?” for equities.

The perennial worry of the equity investor is that a stock market crash is just waiting for her to make her equity investment. The perennial worry of the debt investor is that inflation and interest rates are just waiting for her to make her investments and that immediately after that, the interest rates will spike up.

So, seriously, what do we think of interest rates?

"Everyone knows that currently rates are too low"
"Everyone knows that inflationary pressures are there"
"Everyone knows that interest rates are going to go up"

The current consensus among investors seems to be that the current interest rates are too low given the huge amount of liquidity infused by central banks and the lower policy rates of central banks on account of the COVID situation. Consensus is also there that these measures are temporary and that rates will move up once the economic and medical situation normalises.

Our view is that sure, short term interest rates can move up. It is not necessary for the medium and long term rates to move up in tandem. Hence, it is not inconceivable that the overnight rates and short term treasury bill rates move up from around 3.25% levels to say 4% levels and 5 year Government Securities rates be around 6%.

In fact the yield curve seems to imply that a lot of rate hikes are already priced in.

Consider the following.

- An Investor can buy a 6 year government bond today and hold to maturity (say interest rate of 6.21% annualised)

  Or

- The same investor can buy a 2 year government bond today and hold to maturity and then invest further for 4 years. The current 2 year government bond yield is 4.39% annualised. For this option to be equivalent to the first option of directly buying a 6 year bond, the interest rate on a 4 year bond has to be 7.14% two years from now.#

All calculations and the steepness of the yield curve seems to indicate that a lot of interest rate increases are priced in. As mentioned earlier, we believe the 6-7 year maturity bucket captures most of the steepness of the yield curve. As such, we believe it is better to stick to this maturity bucket, rather than try to predict/ guess interest rate movements in the near term.

#For the CFA and MBA finance types, this is the 4 year forward rate two years from now

A Ship in harbour is safe - but that is not what Ships are built for

A ship which is in harbour is safe and does not have to face the storms at the sea. However that is not what ships are built for.

Similarly, money kept in overnight money market at 3.25% is safe. However if this money is part of a debt allocation which either is supposed to generate cash flow for consumption or as part of an asset allocation plan for the longer term, it is costing around 3.25% p.a. on account of the lower interest rates at the short end as compared to 6-7 year bonds.

Over a 3 year+ period, I would expect that the underlying yield on the bonds will overpower the transient ups and downs in the NAV on account of interest rate movements. Given that the NAV bounces around somewhat on account of interest rate movements, it is not suitable for short term investments. However medium term investors should not unduly worry about the NAV fluctuations.

I hope this note clarifies the approach of the Conservative Hybrid Fund and that investors are clear about the suitability of the fund for their particular investment needs.

Rajeev Thakkar

Chief Investment Officer
July 9, 2021

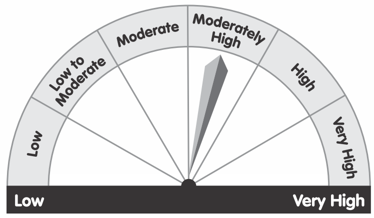
Parag Parikh Conservative Hybrid Fund

This product is suitable for investors who are seeking*

- To generate regular income through investments predominantly in debt and money market instruments.
- Long term capital appreciation from the portion of equity investments under the scheme.

***Investors should consult their financial advisers if in doubt about whether the product is suitable for them.**

Riskometer



Investors understand that their principal will be at moderately high risk.

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