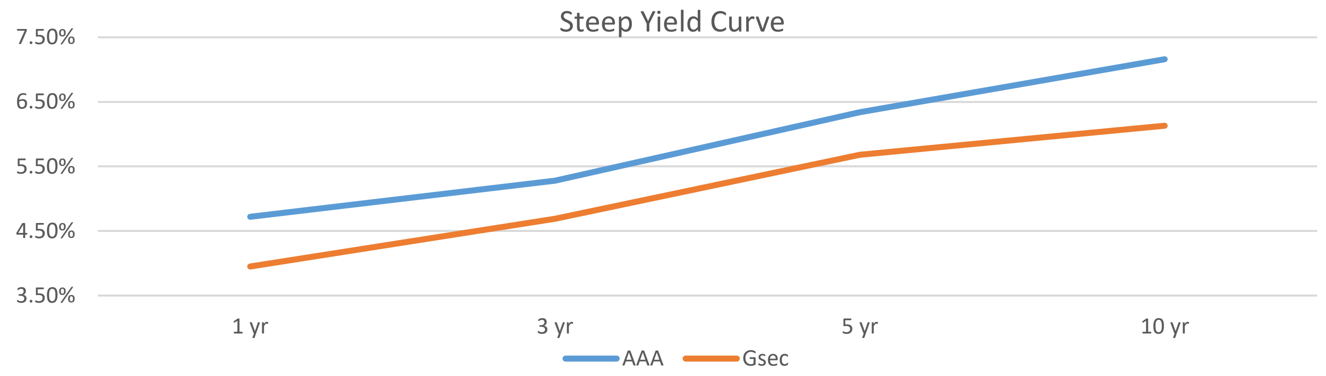
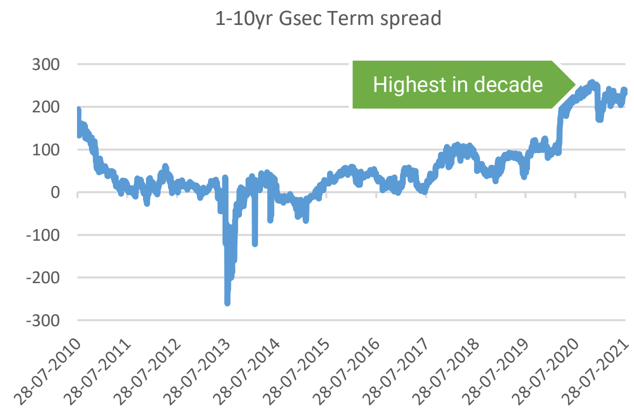
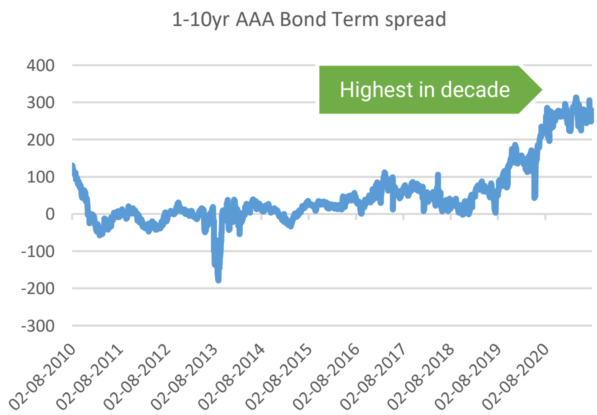
How to benefit from steep yield curve?

July 2021

Thanks to a steep yield curve, (situation where long-term yields are higher than short term yields) many investors today are left confused where to invest their fixed income allocation. 1 year maturing bonds are yielding around 4% to 4.5%, while longer maturity bonds are yielding around 6.5% -7%. The term-spread (1 yr. over 10 yrs. maturity bond yield) of over 2.5% is at decadal high levels.







Data source: Bloomberg as on 27th July 2021

The dilemma amongst investors is on 2 counts:

- Investing in long-term bonds does look attractive as yields are higher, but it also seems risky for many as they expect RBI to reverse policy stance at some point in future. And if yields rise, bond prices may fall and impact the returns.
- On the other hand, investing in short term bonds seems safer option amidst expectations of rising yields, but short-term yields are too low to even beat inflation.

One way to play a typical steep yield curve to your benefit is through target maturity or roll-down strategies that are available in debt funds. Such funds invest in bonds and hold them till maturity which reduces the interest rate risk (risk from rising bond yields) over a period of time.

It is important to note that since yields on the longer end are already high, they have, to some extent, already priced-in rate reversal. With 10 years bond yields trading 250 bps higher than the 1 year bond yields, there is a good margin of safety in case the rate reversal cycle begins. Typically, when term spreads are high, short term bond yields tend to rise faster during rate reversal cycle.

This likely scenario can work in favour of investors who invest in long term bonds (target maturity funds or roll-down funds) and hold them till maturity or for a reasonably longer period. By investing in long maturity bonds today they can earn 150 to 200 bps higher yield than short term bonds, and when yields rise, they will rise sharper in the short-term maturity segment than longer term, thus reducing the MTM impact to some extent on the long-term bonds.

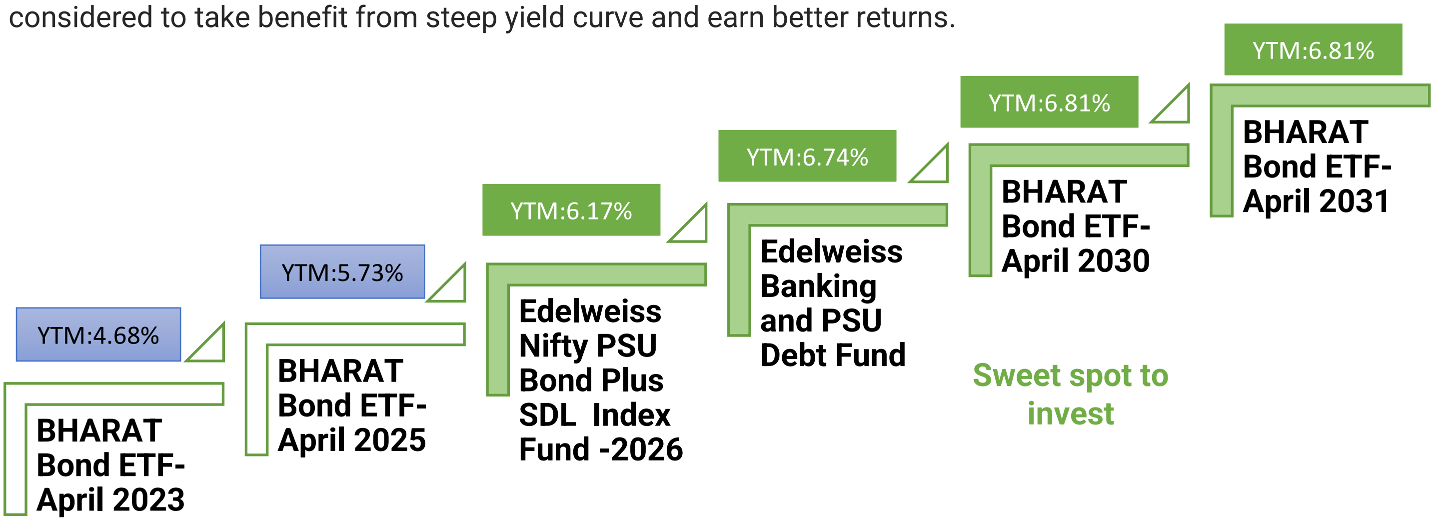
The analysis in the below table shows that investors are better off investing in 5 to 10 years maturity segment today even if yields were to rise in the coming quarters. The holding period returns over 2 to 5 years horizon are better in long term bonds under stagnant or rising yields scenarios.

			Holding period returns			
Bond Maturity (yrs)	Starting Yield	Change in Yield during holding period	1 yr	2 yr	3 yr	5 yr
1	4.72%	--	4.72%	--	--	--
3	5.28%	--	5.28%	5.28%	5.28%	--
5	6.34%	--	6.34%	6.34%	6.34%	6.34%
10	7.16%	--	7.16%	7.16%	7.16%	7.16%
1	4.72%	0.75%	4.72%	--	--	--
3	5.28%	0.50%	4.44%	5.11%	5.28%	--
5	6.34%	0.35%	5.25%	5.97%	6.21%	6.34%
10	7.16%	0.25%	5.69%	6.55%	6.84%	7.07%
1	4.72%	1.00%	4.72%	--	--	--
3	5.28%	0.75%	4.03%	5.03%	5.28%	--
5	6.34%	0.65%	4.33%	5.66%	6.10%	6.34%
10	7.16%	0.50%	4.27%	5.96%	6.53%	6.98%

Rise in yield for long term bonds is assumed to be lower as term spreads are very high. Illustration is only for understanding purpose and it is not an indicative return. Above calculations are done by considering MTM impact when yields are rising.

Edelweiss MF range of Target Maturity and Rolldown funds

Edelweiss MF has a range of target maturity and roll down debt funds with longer maturity that can be considered to take benefit from steep yield curve and earn better returns.



Benefits of Investing in Target Maturity/Roll-down strategy Funds

Returns Predictability	**Indicative yield can be expected if the investors stay invested till maturity.**
Negligible Credit Risk	**The fund invests in government securities, state development loans and bonds issued by PSU (as per respective mandate) that have high credit worthiness.**
Low Cost	**Considering ETF/Index fund structure the expense ratio is very low.**
Flexibility	**Investor can identify pockets of yields that looks attractive with various tenure and choose the one that is more suitable.**
Transparency	**The fund will invest only in constituents that are eligible as per the index methodology**
No Lock-in	**Buy/Sell anytime or through AMC**
Lower Tax	**Tax efficient compared to traditional investment avenues.Taxed at 20% post indexation after 3 years**

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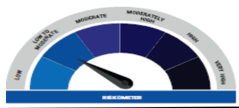
Mutual fund investments are subject to markets risks, read all scheme related documents carefully.

Bharat Bond ETF- April 2023

The product is suitable for investors who are seeking	**Riskometer**
• Income over the target maturity period • An open-ended Target Maturity Exchange Traded Bond Fund that seeks to track the returns provided by NIFTY Bharat Bond Index - April 2023	
*Investors should consult their financial advisers if in doubt about whether the product is suitable for them	Investors understand that their principal will be at low to moderate

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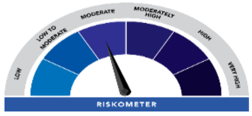
• Income over the target maturity period • An open-ended Target Maturity Exchange Traded Bond Fund that seeks to track the returns provided by NIFTY Bharat Bond Index - April 2025	
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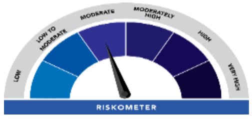
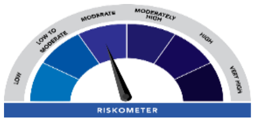
Bharat Bond ETF – April 2030

The product is suitable for investors who are seeking	Riskometer
• Income over the target maturity period • An open-ended Target Maturity Exchange Traded Bond Fund that seeks to track the returns provided by NIFTY Bharat Bond Index - April 2030	
*Investors should consult their financial advisers if in doubt about whether the product is suitable for them	Investors understand that their principal will be at Moderate risk

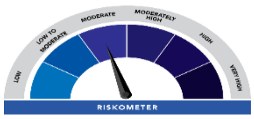
BHARAT Bond ETF -April 2031

The product is suitable for investors who are seeking	Riskometer
• Income over the target maturity period • An open-ended Target Maturity Exchange Traded Bond Fund that seeks to track the returns provided by NIFTY Bharat Bond Index - April 2031	
*Investors should consult their financial advisers if in doubt about whether the product is suitable for them	Investors understand that their principal will be at Moderate risk

Edelweiss Nifty PSU Bond Plus SDL Index Fund – 2026

The product is suitable for investors who are seeking	Riskometer
• Income over long term • An open-ended Target Maturity Index Fund that seeks to track NIFTY PSU Bond Plus SDL Apr 2026 50:50 Index	
*Investors should consult their financial advisers if in doubt about whether the product is suitable for them	Investors understand that their principal will be at Moderate risk

Edelweiss Banking & PSU Debt Fund

The product is suitable for investors who are seeking	Riskometer
• Income Over short to medium term • Investment in Debt Securities and Money Market Instruments issued by Banks, PSUs and PFIs	
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