

NEW NEST EGGS

# Edelweiss' Radhika Gupta and her Bharat Bond bet on passive debt funds

Edelweiss Mutual Fund's assets under management went from Rs 24,000 crore (\$3.23 billion) to Rs 87,000 crore (\$11.7 billion) in just two years, thanks mostly to the Bharat Bond series of target maturity funds. Positioned as an alternative to fixed deposits, TMFs, with their higher post-tax returns, claim to be a solution to India's fixed income investing problem. Not everyone agrees.

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[Anand Kalyanaraman](#), 18 Jan 2022

The Bharat Bond issues, launched in December 2019 and positioned as a superior alternative to fixed deposits, have seen strong investor response

These and other TMFs offer high-quality bonds that mature around a target maturity date in a low-fee, open-end, tax-efficient structure

These issues have been instrumental in catapulting Edelweiss Mutual Fund higher in the AUM league tables

But with interest rates expected to rise, many experts think they are not a good choice for investors at the current juncture. Edelweiss disagrees



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Radhika Gupta couldn't be more bullish on passive debt funds, calling them a "guaranteed game-changer". Why wouldn't she? After all,

Edelweiss Mutual Fund, of which she is the managing director and chief executive, manages the most popular passive debt fund in India currently—the government’s Bharat Bond series. Its December 2021 issue of Rs 1,000 crore (\$135 million) was oversubscribed more than 6X, among the highest since the series was launched in December 2019.

In fact, the Bharat Bond series has catapulted Edelweiss from the #20 spot among India’s 40-plus mutual fund companies to #14 in terms of assets under management (AUM). The company’s AUM zoomed from about Rs 24,000 crore (\$3.23 billion) in December 2019 to Rs 87,000 crore (\$11.7 billion) in December 2021. Of this, nearly Rs 44,000 crore (\$5.9 billion) is Bharat Bond AUM.

Gupta’s all-in bet on the Bharat Bond series is backed by two things—that it’s a passive debt fund and, on top of that, a target maturity fund (TMF) to boot.

Passive debt funds, like their equity counterparts, seek to ‘passively’ track the composition and performance of a benchmark index, unlike active funds which seek to outperform the index by ‘actively’ investing in specific securities. Passive funds are seen as cheaper for both the fund house and the investor, as well as a safer option for investors.

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While that alone is possibly enough to reel in investors, the Bharat Bond series' TMF status is the icing on the mutual fund cake. TMFs, much like the name suggests, are funds that have a specific date of maturity. Like a fixed deposit (FD), for example.

That's the position Gupta's taking—an alternative to fixed deposits. And a superior alternative at that. "Fixed income investing is a big problem in India. TMFs are a better-than-FD solution, solving for an Indian investor in the Indian context," says Gupta.

For one, interest rates on FDs have been on a downward trend for the last couple of years—going from about 7.5% to about 5.5%, on an average. Making matters worse is the tax on fixed deposits, with the interest being taxed at an investor's slab rates. This can go up to 30%. So, real rates have turned negative in many cases—what investors earn on their deposits is often less than the increase in their costs.

TMFs are a ‘Jio’ opportunity for debt funds because the fixed deposit demand in India is unsatiated.

— RADHIKA GUPTA, MANAGING DIRECTOR AND CHIEF EXECUTIVE OFFER, EDELWEISS MUTUAL FUND

And yet, FDs remain some of the most popular savings options in the country. A survey by market regulator Sebi in 2017 found that 95% of Indian households prefer to park their money in bank deposits.

TMFs, on the other hand, function like FDs, but the gains at exit—if you hold them for more than three years—are taxed at 20% after indexation benefit. This pushes up the post-tax returns, especially for those in higher tax brackets.

The demand has driven more mutual fund houses into launching TMFs of their own. Since Bharat Bond 2023—India’s first TMF—12 more AMC’s have either filed for or launched TMFs. “So, clearly there’s no shortage of interest in the category, which is quite nice to know,” says Gupta.

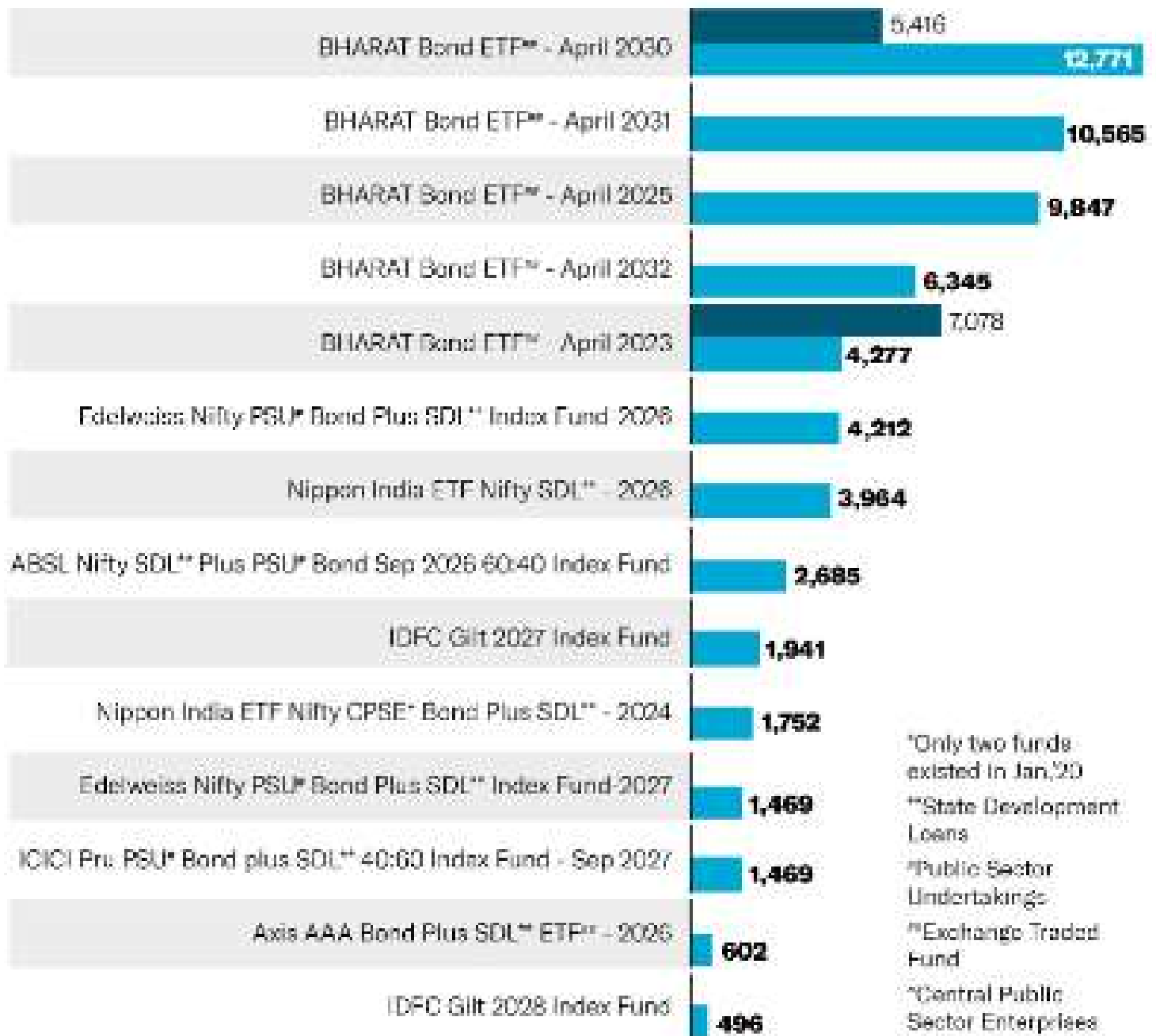
The AUM of the TMF universe has crossed Rs 62,000 crore (\$8.3 billion) as of December 2021. According to a source in the industry, much of the growth in the passive category over the last two years came from debt funds. Edelweiss' first-mover advantage puts it in pole position.

# Taking off

Since their introduction in Dec 2019, Target Maturity Funds (TMFs) including the Bharat Bond series, have seen strong growth

Assets under management (AUM) (Rs cr; as of Dec 31, 2021)

■ Jan,'20\*   ■ Dec,'21



\*Only two funds existed in Jan,'20

\*\*State Development Loans

\*Public Sector Undertakings

\*\*Exchange Traded Fund

\*Central Public Sector Enterprises

However, with rising inflation, interest rates seem set to rise, possibly leading to an investor being locked in at lower rates when it comes to long-term instruments like TMFs. Offsetting that, though, is the tax-friendliness. India's annual budget for the coming year is also set to be announced on 1 February, and Edelweiss and the other players in the TMF space would be hoping for no nasty surprises. The popularity of the TMF structure hinges, in no small measure, on favourable tax treatment.

## Same but different

“The Indian investor essentially thinks of fixed income investment in terms of two questions—How much does it give? In how much time?” says Gupta. TMFs, like FDs, answer those questions with the same ‘fill it, shut it, forget it’ approach.

If held until maturity, TMFs offer predictable returns. The **yield-to-maturity** (YTM) in the TMF at the time of investment is a concept comparable to yields from an FD. For instance, the YTM of the recent Bharat Bond April 2032 issue was 6.92%, while the interest rate on long-tenure bank FDs, on average, is around 5-6%.

Holding until maturity also does away with the ‘**interest rate risk**’ often associated with many debt mutual funds. Bond prices and interest rates are inversely linked—a rise in interest rates lowers the price of existing bonds and vice versa. Interest rate risk is something to watch out for until the maturity of the bond, after which repayment and bond closure cease



This is primarily because they invest in 'AAA' debt of public sector companies and debt papers issued by the Central government (G-Secs) and State Development Loans (SDLs).

AAA ratings are the highest among those awarded to investment-grade debt. So the risk of default—known as credit risk—by these government-backed entities is considered nil or negligible. Some TMFs also invest in AAA-rated corporate bonds that are perceived as safe.

Besides, being passive funds, TMFs have a very low fee structure—as low as 0.0005% in Bharat Bonds, and 0.15-0.3% in others. The return on a TMF, if held to maturity, is approximately its YTM at the time of investing minus the fee.

## Smart build

The construct of TMFs like Bharat Bond is essentially this: hold high-quality bonds that mature around a target maturity date in a low-fee, open-end, tax-efficient structure.



TMFs aren't just a better friend to investors than fixed deposits, they're also the more liquid cousin to fixed maturity plans (FMPs).

FMPs are closed-ended funds, meaning that after the offer period, they cannot be bought or redeemed from the fund house until maturity, except on the stock exchanges. TMFs, on the other hand, are open-ended funds—they're available for purchase and sale continuously irrespective of their maturity status. "I think TMF is smart financial engineering, and with their open-end structure, they have the potential to completely replace FMPs," says Sumit Duseja, co-founder of Truemind Capital Services, a financial advisory firm.

And while FMPs also have an exit open on the stock exchange, liquidity on the bourses is often low for FMPs and so, TMFs have an edge.

Disclosures are also more frequent and transparent in TMFs than in FMPs and other similar products such as roll-down funds. For instance, portfolio disclosures are available daily for the former, while they're given at the end of the month for the latter. "A large portfolio investor might want to have this comfort," says a fund manager at a leading fund house in India. They, and others quoted in the story, requested anonymity as they aren't authorised to speak to the media. After the crisis of confidence in the debt fund industry over the past two to three years, many investors now seem to equate more and frequent with better, when it comes to disclosures.

A mutual fund analyst quips that FMPs were sometimes “actively mismanaged” with high-risk, low-rated papers dumped into them, leading to some defaults in the past few years. The fund manager, though, counters by saying that different FMPs cater to different appetites of risks and returns. “Expectations of higher returns are joined at the hip with higher risk.”

## **Not always interest-ing**

Despite the multiple advantages TMFs have, they weren’t the first choice for the government’s Bharat Bond series. The original idea was to structure it as a [constant maturity fund](#) or a [dynamic bond fund](#), says Gupta. But while studying various options from around the world for a suitable structure during the bidding process, the Edelweiss team came across a TMF product called iBonds, launched by global investment management company BlackRock in 2010. iBonds essentially hold a diversified portfolio of bonds with similar maturity dates.

“The fact that we proposed something on the lines of TMF when we went into the bid probably helped us,” says Gupta. “To be frank, it’s the most transformative thing in the industry in the last two years,” she adds.

But not everyone is sold on the claim. “I don’t think it’s a Eureka moment. Such products have been tried and tested globally for many years with large AUMs in place,” says the fund manager. They argue that TMFs are the same as FMPs that have been around for long, but with an open-end structure.

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TMFs are not an investment vehicle for everyone, either. Those looking for a short-term investment will have to look elsewhere because exiting from the fund before its maturity could result in the interest rate risk playing out and the portfolio suffering losses if interest rates rise.

Besides, there are periods when active debt strategies play out better than passive ones, say experts. The strategy has had a good run over the past few years, but rising interest rates are going to put passive debt investing through its phases. “Today, we are on the cusp of a rising interest rate environment. A passive debt fund like a TMF is not optimal at this stage, especially for long tenure investments,” says the product head of another leading fund house.

“It could lead to an investor being locked in at lower rates and losing out on the benefit of rising rates in the future,” they add. Rising rates could cause the bond prices to fall, causing heartburn to investors and early exits even if the intention earlier was to hold the bonds to maturity.

Truemind’s Duseja, too, agrees. “On the contrary, these long-tenure passive debt funds are well-positioned to benefit in a declining interest rate scenario by locking in higher yields,” he says.

Gupta, though, waves away the scepticism, saying that most fixed income investors are the hold-to-maturity kind and TMFs like Bharat Bonds are meant for such investors seeking predictability in returns. “They come in

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with a 'number' in mind while investing and will likely realise that number by holding the TMF till maturity," she says.

## Challenge ahead?

Sumit Duseja, co-founder of financial advisory firm Truemind Capital Services, hints at challenges when TMFs start putting money in lower-rated debt. "Currently, passive debt funds are investing in high-rated and highly liquid papers. It would be interesting to see the impact when they go down the rating ladder."



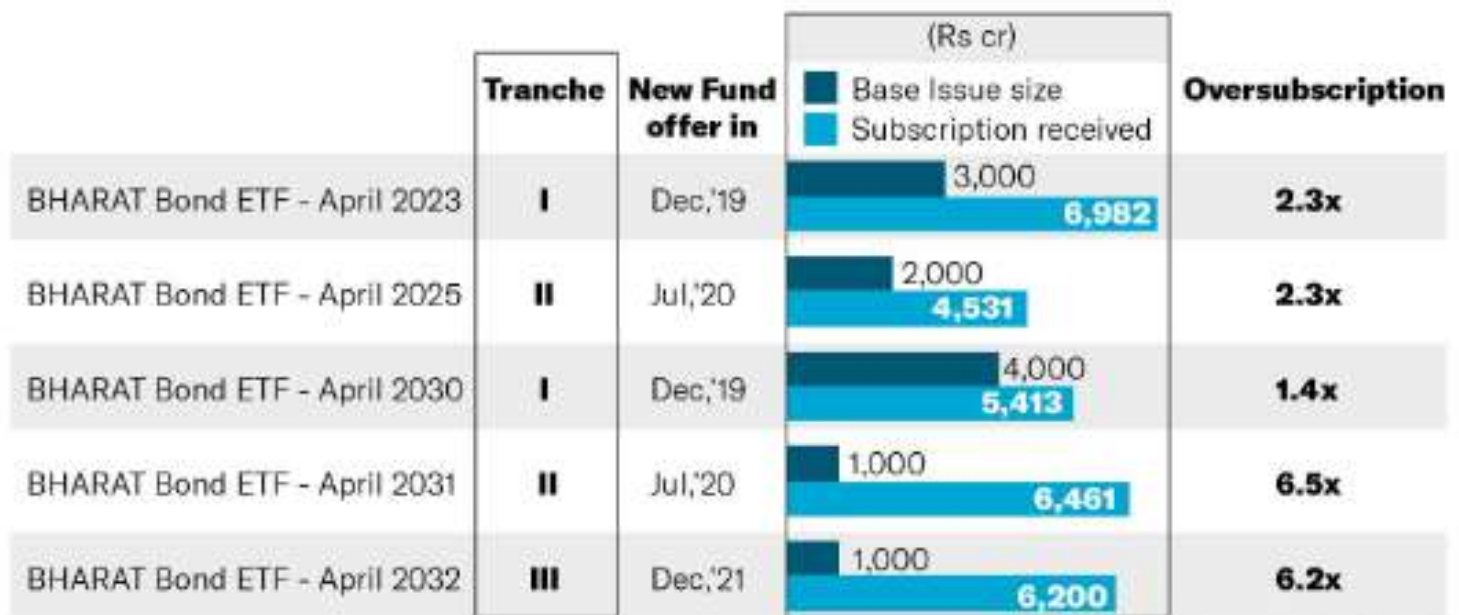
The thing with interest rates is that people have been expecting them to go higher for some time now, says the fund manager. The risk can't be avoided beyond a point. "If your intent is to hold till maturity, it should not matter if rates rise and bond value falls," they say.

One way to counter this would be to invest in short-tenure or floating rate instruments for now. These are better positioned to take advantage of a likely rise in interest rates due to their ability to reset or reinvest at a higher market yield in the future. "Investors are going to question passive debt fund managers about negative returns or low returns in the next few years," says the product manager, predicting that investor response to

That day is probably not today. The strong investor response in the Bharat Bond issue in December suggests continuing good demand for TMFs despite the expected rise in interest rates. And supply invariably flows in to meet demand.

## Robust response

Investors have lapped up the new fund offers (NFOs) of the Bharat Bond ETF\*, especially the recent ones



\*exchange traded fund

“Over the past year or so, many fund houses launched [debt exchange traded funds](#) (ETFs) to give investors alternatives to deploy money from maturing FMPs,” says Anil Ghelani, who heads Passive Investments and Products at DSP Mutual Fund.

Edelweiss, for its part, plans to double down on its TMF issues and maintain its dominance in the space. “Most industry players have one or two products. We have seven, the widest ladder in the industry. We’d want the full ladder—everything from the 2023 series to the 2032 series,” says Gupta.

The company has three filings waiting for approval from Sebi, with another launch or two lined up for the current quarter. These launches are public sector bonds—SDL funds and not Bharat Bonds. That could work to the company’s advantage, given that non-Bharat Bond TMFs command better fees than Bharat Bonds.

“Given the negligible fee and the high costs, including marketing expenses, the Bharat Bond mandate is practically charity and loss-making for Edelweiss AMC,” says the fund manager quoted earlier. Rivals say that Edelweiss got the Bharat Bond mandate primarily due to the very low fees it quoted in the commercial bid.

Gupta, though, says that the bid was a transparent **technical-cum-commercial** one with the technical aspect getting a 70% weightage. Gupta also claims that the whole passive debt programme, the Bharat Bond and the non Bharat Bond series taken together, makes money for Edelweiss. “How and how much I don’t need to disclose to the market,” she adds.

Insinuations aside, the fact that the Bharat Bond series has had a major impact on customer acquisition at Edelweiss and its brand cannot be denied. “Everything—from our non Bharat Bond debt book, equity, and international book—took off. We acquired so many customers who became customers in other products,” says Gupta.

The CEO, however, tempers her bullishness on TMFs with the practical—she acknowledges the fact that large-scale migration of FD holders to TMFs will be gradual. “It’s not going to happen overnight. It will start with sophisticated investors and others will eventually get used to it,” she says. Still, there’s enough interest in the sphere currently to drive cheer for fund houses. Anything else is a bonus.

*Lead image credit: Ylloh/Pixabay*