Can Butterfly Wings Explain Portfolio Optics?

DSP MUTUAL FUND

Last two years have seen the debt market yields come down in a linear fashion and thus the struggle to generate portfolio returns from here on is a real one. The last two years were also marked by hall mark events to hit the financial world which led to a series of regulatory changes in the mutual fund space such as high exposure norms towards more liquid instruments, graded exit loads and introduction of stamp duties. Credit events, unfolding of the NBFC crisis, liquidity driven market drawdowns on the debt portfolio, have forced lenders, investment managers as well as investors to recalibrate their investment processes and define their risk boundaries.

Some major shifts that took place on the mutual fund landscape since August 2018 till date:

Categories	AUM Aug 2018	AUM JUL 2020	AUM Change	% of Change
Overnight Fund	740	73,395	72,655 ▲	9818% ▲
Liquid Fund	5,68,605	4,41,734	(1,26,871) ▼	-22% ▼
Ultra Short/ Low Duration/Money Market	2,24,293	2,61,724	37,431	17%
Short Term/ Banking PSU/ Corporate Bond	1,73,244	3,37,808	1,64,564 ▲	95% ▲
Credit Risk	91,032	28,707	(62,324) ▼	-68% ▼
Other Debt categories	1,15,861	94,749	(21,112) ▼	-18% ▼
Gilt/ 10y Constant Gilt	8,973	23,159	14,186 ▲	158% ▲
FMPs	1,20,903	91,568	(29,335)	-24%
Total Debt	**13,03,650**	**13,52,844**	**49,194**	

Overnight category emerged strong; taking away some share of the Liquid category.

Money moved within the category to Money market funds from Low Duration, as the former had a relatively superior credit profile.

Money moved largely from credit and similar strategies to high quality AAA and PSU bonds dominated strategies.

Government Securities category has seen the largest growth spurt ever in this cycle.

Source: AMFI Data for July 2020 and MFIE for Aug 2018

Most of the above trends signal one common theme '***Flight to Safety trade***'. Also the trade has given outsized returns. Recency Effect weighs heavily on most investors' mind.

So what next? What should be the key considerations while building your portfolio from here on?

We believe that the two drivers of Returns in a debt portfolio can be Duration and Credit Risk.

The Reverse Repo at 3.35% is the new anchor given the comfortable liquidity at 6 lac crores in the system, while Repo remains the same at 4%. The term spreads have almost collapsed in the 1 to 3-year bucket. The base yield curve is flat with AAA spreads ranging between 15 bps to 95 bps over the repo much below the historical averages of 125 bps to 175 bps.

Credit offtake remains weak due to the uncertain economic environment. Negative GDP forecast by RBI does not provide any comfort yet. This could cause significant credit stress especially when the moratorium ends.

In short, ***we need to be mindful of the credit overlay in the portfolios and take duration risk only for that which we have signed up for***. Let us understand this better in the next few lines.

What are we doing differently?

A close look into our debt portfolios could reveal our strict boundaries which apart from credit and duration have a strong weightage to 'Liquidity'. This also means that we prefer to ***choose a security with relatively lower YTM; where the probability of spread widening is lower*** in case of liquidity squeeze kind of situation. For e.g. Currently we prefer a higher exposure of the 5-year G Secs over Corporate Bonds and Perpetual Bonds in our DSP Banking & PSU Debt Fund.

With strict boundaries, we mean for e.g. If regulator mandates Low Duration category to have a Macaulay Duration between 6 months to one year, then we would ***not like to expose investors to the higher volatility of a 2.5 - 3 year or a higher maturity paper while trying to compensate for lower term spreads***. We will practice restraint of investing most of the portfolio in the mandated band. Thus we have tried to maintain duration discipline despite the temptation to run portfolio strategies which are not in line with the characteristic of the fund category.

Credit Team's Communique

The Covid-19 pandemic has indeed caused chaos in the financial sector. With lockdowns across the country, demand patterns still remain hard to predict. In fact, till there is a cure for the virus, the market's medicine seems to believe in the tonic of ***systemic liquidity***.

DSP credit approach strives to provide superior risk adjusted returns to the investor. Credit risk, spread widening and illiquidity risk of a security are the metrics used for credit evaluation. Our framework recognizes volatility and price movements – be it in bond or equity market, bid offer spreads (the first indicator of illiquidity) and other early warning alerts including shareholding pattern, Board and Auditor changes. The question with which we start out is whether the paper will be liquid enough to exit, come redemptions or sudden change of mood in the market sentiment.

We have been conservative when it comes to Banks and NBFCs currently. The moratorium data has been a mixed bag and different banks/NBFCs have different approaches to quantify the data. Now with the moratorium end date closer, focus will shift gradually towards solvency of these companies – which essentially means tracking the asset quality deterioration, improvement in collection numbers which are strong cash flow indicators. The organisation's ability to provide capital will be at fore. With the economy in distress, we were expecting some element of soft recognition norms so that the solvency of financial institutions is not immediately threatened. We are sure that the NBFCs and leading banks will be more forthcoming with quality of disclosures which is important to our investment thesis.

We will continue to invest based on our conviction in the sequence - liquidity of the underlying securities, governance, cash flows predictability, transparency and then followed by umbrellas such as Group/ security cover/ability to refinance.

Our investment process belies the expectation that a strong parent is needed for a mutual fund – we believe that a mutual fund should be self-reliant on all of the above parameters, which is the basis of the Trust structure.

So while the market popularly focuses on different things at different points in time – YTM when feeling secure, liquidity and portfolio when feeling otherwise, we hope to maintain a consistent approach – liquid securities of well researched companies at all points of time.

To Conclude

In the 1850s, a naturalist Henry Walter Bates found two sets of butterflies which were not of the same species but their wings looked almost the same to the naked eye. Through closer study, he discovered that the butterflies with toxic wings were able to operate freely and relatively unmolested with no fear of predators. The other set of butterflies; the "mimics" also went untouched as they had developed similar looking wings though they were not toxic. Predators attacked none of them as they simply wouldn't take the risk of mixing up the two. This phenomenon is called ***The Batesian Mimicry.***

It is important to remember this Batesian Mimicry concept when it comes to selecting our investments too. ***In investing though it's the reverse; the mimics are precarious as they have developed optically similar looking portfolios and durations while YTMs may differ at the time of the investment. Often a closer look will provide the reason for the difference***. We have seen investors who exactly know what they are getting into and it is respect worthy. It is completely alright to invest anywhere as long as we recognize what we have signed up for but unfortunate when we don't.

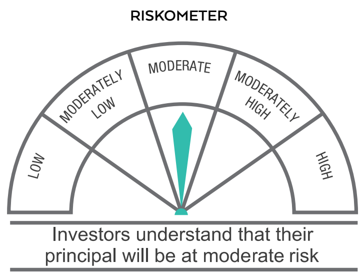
Know the type of wings. Know your Investment Manager.

Product Labeling

DSP Banking & PSU Debt Fund (An open ended debt scheme predominantly investing in Debt instruments of banks, Public Sector Undertakings, Public Financial Institutions and Municipal Bonds.)

This Scheme is suitable for investors who are seeking*

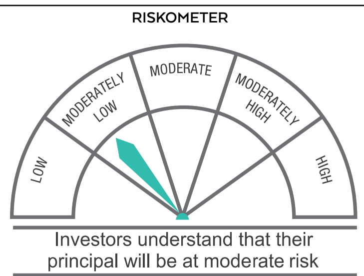
- Income over a short-term investment horizon
- Investment in money market and debt securities issued by banks and public sector undertakings, public financial institutions and Municipal Bonds



DSP Low Duration Fund (An open ended low duration debt scheme investing in debt and money market securities such that the Macaulay duration of the portfolio is between 6 months and 12 months (please refer page no. 20 under the section "Where will the Scheme invest?" in the SID for details on Macaulay's Duration).)

This scheme is suitable for investors who are seeking*

- Income over a short-term investment horizon
- Investment in money market and debt securities



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

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