Credit issues in fixed income portfolios – *A quick update*

Background

Debt funds can be broadly divided into liquid/ money market funds and bond funds. Liquid funds invest in very short term papers and are chiefly used for cash management. Bond funds can invest across the yield curve depending upon their maturity mandates and investment horizon.

Lower rated (credit) exposure in bond funds

Between 2013 and 2015, there was a sharp increase in the corpus of credit funds (bond funds with high allocation to lower rated papers) which has changed recently. Credit events in the last year have affected investor sentiment towards this sector and the total corpus today is lower from the peak that it had hit in August 2015.

Apart from the total corpus the pace of deterioration in the portfolio rating mix has also stabilized. Over the last year portfolio allocations to instruments rated below AA or equivalent has remained close to 60%. While this stabilization is a positive development, it should be noted that the allocation to lower rated instruments in absolute levels are still dramatically higher than their levels in 2013 as can be seen in the table below:

Date	Rating Mix	Average exposure (%)	Corpus (crs.)
3 years ago (Mar-13)	AAA and equivalent	25.6	16,761
	Upto AA	28.7	
	Below AA	44.7	
Peak (Aug-15)	AAA and equivalent	22.5	70,066
	Upto AA	23.6	
	Below AA	53.9	
Current May-16	AAA and equivalent	19.2	50,026
	Upto AA	22.5	
	Below AA	58.3	

**Credit funds include all income funds with AAA and equivalent exposure of less than 30%. Source: ACEMF.*

This hiccup in flows into credit fund has revived interest into higher quality debt funds. The total AuM of higher quality short term funds has gone up by Rs 7,025 cr between Aug 15 and May 16.

Liquid fund experience

Since liquid funds run using a different philosophy, they have largely not been affected by this move towards higher credit allocation by debt funds over the last 3 years. Over this period the allocation to AAA/P1+ or equivalent instruments by liquid funds has been in the range of 98-100% of their portfolios. As a result, investor flows into liquid funds have remained robust even when credit funds have taken a hit.

Market update

After contracting steadily due to heavy yield-seeking buying by credit funds, corporate spreads have moved up over the last year as can be seen in the charts below. However the absolute spreads are still off from their 2009 levels.

Source Bloomberg

Credit outlook

While economic growth is showing signs of improving, credit stress in highly leveraged firms continues to be a challenge. According to an analysis by CRISIL, in the second half of FY 15-16, the credit ratio (ratio of upgrades to downgrades) was 0.76. A ratio of less than 1 indicates that there were more downgrades than upgrades. The analysis also shows that the debt weighted credit ratio (quantum of debt upgraded versus downgraded) stood at 0.2 – the worst level in the last 3 years. This indicates that heavily indebted companies have been more downgraded compared to less leveraged firms.

The challenge is particularly acute in certain sectors such as infrastructure and metal-linked firms where according to CRISIL the debt under stress is at a record level. The picture is not all grim however. As the economy improves, we expect certain other sectors (such as consumer oriented) to benefit from higher demand and improve their credit metrics. For example in the 12 months between Oct 2014 and Sep 2015, there were more than 2 upgrades for each downgrade as the broader economy improved. The current downgrade cycle reflects the weak global environment particularly for commodities.

Apart from the credit risk concerns, the other reason that credit portfolios face a significant risk is the lack of liquidity in the secondary market in lower-rated instruments. This presents a contagion risk for the markets since in case there is a need for any investor to liquidate its portfolio over a short notice, it will be exceedingly difficult to do so.

Managing credit risk

Even though there continue to be some concern regarding credit risk, there are several controls that funds put in place to mitigate risk.

At a regulatory level, SEBI has tightened the exposure norms for Mutual Funds. Exposure to a single issuer has been reduced from 15% to 10%, exposure to a single sector has been reduced from 30% to 25%, and a new limit of 20% in aggregate exposure to a borrower group has been introduced. This has been designed to increase diversification / reduce concentration risks.

Earlier SEBI had tightened the norms for liquid funds limiting the maximum tenor of investments to 91 days. In practice most of liquid fund holdings are less than 60 days to maturity. This further improves the liquidity and lowers risk for this category of funds.

In addition the fund also has additional risk controls in place. Each issuer is subject to a thorough credit research process before being admitted to an Investment Universe. The exposure limit for each issuer is also limited by its rating.

Summary

The issues around credit quality can be summarized as:

- Primarily related to certain sectors (metals, infrastructure)
- High leverage/debt levels are associated with deteriorating quality
- Impact schemes that are substantially invested in non-AAA assets
- Recent changes to regulations have reduced some risks related to concentration/diversification

Investors who desire low risk portfolios should consider funds that are primarily invested in AAA or equivalent papers and stay biased towards high quality and high liquidity.

Source: Bloomberg