Business Standard

Debt can be as risky as equity

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Corporate credibility, interest rate environment and inflation can eat into your returns or even make them negative

There are people, who avoid equity markets thinking these are gamblers' dens. And, feel debt investing is safe with no risk, and that is why returns are low from such investment vehicles.

Credit risk: Debt is actually lending your money to the government or any company, in return for a pre-decided interest (coupon). Where there is lending, there is always a risk of the lender not being able to return your principal or not being able to service the interest portion of the deal. This is known as credit risk. The stronger the financials of the entity to whom you lend, the better the chances of your principal coming back with the promised interest. Thus, debt papers from the government and strong companies usually have a lower interest rate, as the risk is lower. Those with weaker fundamentals and reputation usually offer higher returns. You can see this in bank fixed deposits, where public sector banks usually have lower interest rates compared to co-operative banks. In mutual funds and Fixed Maturity Plans (FMPs), this risk is managed by holding bonds and other debt instruments rated highly by the rating agencies.

Interest rate risk: The bond you hold is traded in the market on a daily basis. Suppose you hold a bond giving an 8 per cent coupon, bought for Rs 100. Subsequently, if interest rates go up, there will be new bonds in the market which give a coupon of, say, 8.5 per cent. The value of your bond falls. If you try to sell your bond in the market, it will not fetch the initial amount you paid for it. In a reverse scenario, where the rates fall to, say, 7.5 per cent, your bond will be much in demand for the higher coupon it fetches. Thus, you will be able to sell it for more than Rs 100. The instruments with longer maturities will be more susceptible to interest rate risk. This risk is usually managed by holding the bond to maturity. So, you keep getting your 8 per cent interest at half-yearly intervals and at maturity, the face value of the bond, that is, Rs 100, is paid back to you. This is how FMPs also manage their interest rate risks. If you buy a three-month FMP, the portfolio will have only those bonds which mature in 91 days. So, too, for other debt mutual funds. The mandate of the fund is matched to the maturity period of the bond.

Reinvestment risk: This basically means you might have to invest future proceeds – interest payouts as well as principal repayment – at a lower rate.

Since debt instruments usually yield lower returns, they may also give negative real returns. This is called inflation risk. For example, if a bank deposit gives you 8 per cent return (taxable) and the inflation is 6 per cent, your actual return is minus 0.4 per cent, if we assume the marginal tax rate to be 30 per cent).

Liquidity risk: You may sometimes not be able to readily access your funds or may have to pay a penalty to liquidate your funds when you need them. This is called liquidity risk. This risk is usually managed by having some portion of your funds which might be required at short notice in investments, which can be redeemed quickly without penalty. These would include liquid funds and bank fixed deposits.

During the 2008 crisis, there was panic amongst investors to redeem their investments from FMPs and other debt funds. Though people got their money back in the stipulated time period, some investors lost because they had to pay a stiff penalty to get out of products like FMPs which are essentially close-ended products.

The presence of risk does not mean you avoid the investment altogether. There is risk even while walking on the road; that does not mean you remain locked indoors. It is important to understand the risk and take steps to mitigate it. The key to successful investing is to have a judicious mix of debt, equity and other asset classes, which will give a decent return at an acceptable risk.

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