The Yield Curve - Part 2

Portfolio Management Strategies

Portfolio management strategies can be broadly categorised as Active Management when the fund manager takes actions speculating a movement in the yield curve or Passive Management when there is very little interference by the fund managers.

Passive strategy:

- Involves less churning of portfolio
- Can follow a buy and hold strategy or replicate the portfolio and performance of a benchmark index. No active fund management involved hence have low operational cost.

Active strategy:

- Professional fund managers decide the underlying investments.
- Investment decisions made on fund manager's view on macroeconomic & microeconomic factors, central bank policies and yield curve movements.
- Churning is done to beat the market in performance in accordance with the fund's predefined investment mandate.
- Performance can be measured against the appropriate market index, or benchmark, based on stated investment strategy .
- An active fund manager tries to preserve the capital when interest rates are expected to rise or achieve attractive capital gains when expectation from interest rates is to decline.
- Fund manager may reduce the portfolio duration when interest rates are expected to increase and vice versa.
- Credit analysis of the investment portfolio is done to maintain the pre-decided risk profile of the portfolio.
- Analysis of intrinsic value of bonds is done to manage the mark to market effect on the portfolio.

Some Interesting Fund Management Strategies Used In Mutual Fund Industry:

1. **Roll Down Strategy**: It is an active fund management strategy used in debt fund management. This strategy involves creating a portfolio of a certain maturity which looks rewarding on the yield curve and allowing the maturity to fall, till the fund hits the target date and then either resets it once the maturity rolls down to zero or adopt a different strategy depending upon their anticipation of yield curve movement.

   Since maturity reduces over a period of time, the interest-rate risk also reduces hence is a popular strategy when the yield curve is bottoming up and later a rise in interest rate is expected. When the interest rate starts rising, staying in a product with lower duration reduces the mark to market effect and capital loss. Whenever the fund sees inflows and outflows, it buys or sells bonds with tenure which maintains the residual maturity of the fund.

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2. **Barbell Strategy:** The barbell strategy is a style in which the fund manager buys short term and long term bonds and does not include bonds with intermediate term maturity. As a result this strategy helps in reducing the downside risk and at the same time invest in instruments with longer maturity to get higher yields. This strategy is usually adopted when the yield curve is flattening and is unsuitable when the yield curve is expected to steepen.
   The strategy lowers risk as short-term and long-term bonds' returns tend to be negatively correlated. So when interest rates increase, the short-term bonds will be rolled over and reinvested at a higher interest rate. The reinvestment will offset the decrease in the value of longer-term bonds. On the other hand, if interest rates decrease, the value of the longer-term bonds will increase.

3. **Enhanced index fund strategy** : Some index funds employ an enhanced index fund strategy and are hybrid in nature. Their fund managers pick and choose among the investments tracked by the benchmark index in order to provide a comparatively better return. When the index is not performing well , this hybrid approach may help to give slightly better returns via-a-vis the overall index. Since there is an active involvement of fund managers these funds may also underperform as compared to the index. Their fees are higher than pure passively managed funds.

Use of Floating Rate Instruments as an investment strategy :

- Floating rate funds are SEBI categorised Mutual Fund's scheme category which is mandated to invest minimum 65% in floating rate instruments.
- Floating rate instruments are financial instruments which follow a certain benchmark. The changes in the related benchmark's rate cause the interest rates of the financial instruments to change. For example if the benchmark is 10 year government security rate then in a rising interest rate scenario there will be a rise in 10 year government security rate resulting in a rise in the returns from floating rate instrument.
- Thus, floating rate funds are aimed at providing flexible interest incomes to investors in a world of rising interest rates.

Questions to ponder on ....

- Do we have enough floating rate instruments in indian debt markets?
- What alternatives do fund managers have when they do not get enough floating rate instruments for their funds?
- Will floating rate funds suite your core investment needs or satellite investment needs?
- **Talk to your relationship manager to help you choose most suitable floating rate funds for you.**

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