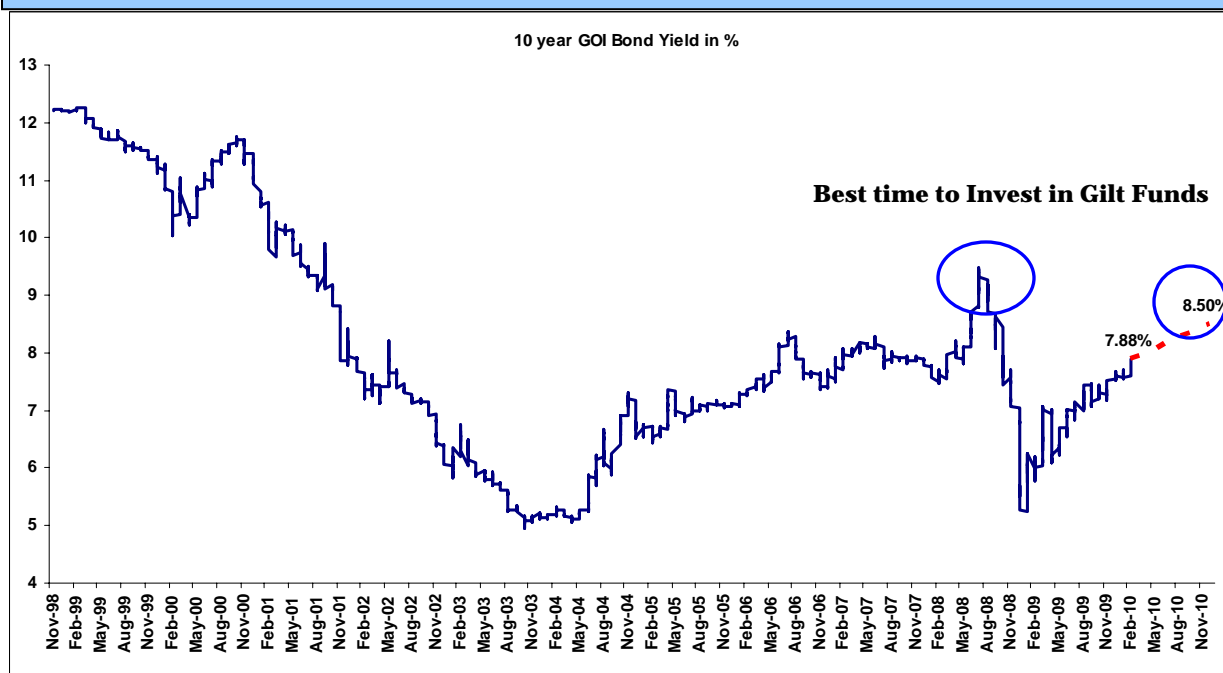


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The year of 2008 had ended on bullish note for the Government of India (henceforth GOI) Bonds. It was the year of the two “G’s” viz Gold and Government Bonds. Both of the asset classes returned between 25-30% in that year, thanks to the safe haven demand, amidst one of the worst global financial crisis of the century. Later in January 2009, the yield on the 10 year GOI bond touched a low of around 5.25% (Chart I). Since then it has backed up to 7.88% now, almost by 250 bps, due to worries on higher supply of GOI bonds, a rising inflation, fiscal issues and a hawkish RBI.

Chart I: Government of India Benchmark 10 year Bond Yield in %



Source: Delta Global Partners Research and www.tradingeco.com Data as on 19th Feb 2010. Red Dotted line is one of the probable scenario in future that may or may not happen.

Fixed income or debt securities are issued by banks, corporates, financial institutions, GOI etc. As an asset class, debt securities cushions the overall portfolio risk due to its relative negative co relation with other asset classes such as stocks. Debt securities typically provide regular income which absorbs some of the potential capital losses from other asset classes in the portfolio, if any. In long run Government Debt securities should return around the average nominal GDP growth rate of the country. GOI bond markets in India being a wholesale one, Gilt funds are a good vehicle for retailers to participate in GOI bond markets.

Investors in fixed income or debt securities or debt funds, benefit when the interest rates come down and vice versa. As the rates come down the value of securities held by the fund moves higher, taking the NAVs also higher with it. The opposite of that is true too. Gilt Funds are the ones which are mandated only to invest mainly in securities issued by GOI. Some portion is also invested in overnight markets as a liquidity management exercise. Since Gilt funds hold only GOI securities and the government is

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not expected to default, Gilt Funds don't carry any credit (default) risks, which other non government issuers may carry. Though it carries all the other risks which any other debt funds do such as Duration, Illiquidity Risk, and Reinvestment Risks etc.

When to buy a Gilt Fund, viz increase the exposure as a tactical strategy?

When the interest rates peak and are expected to move lower (Chart I), it's the most appropriate time to buy Gilt funds. Interest rate usually moves in cycles of 2-3 years in tandem with the underlying economic cycles. Though judging the same will need some extensive analysis, but some simple clues can be used effectively by investors. Some of them are:

When the economy has been growing rapidly (above long term trend) for the last few years and probably the growth is likely to slow down from there. And the indicators to watch for are : Bank credit off take starts slowing (lower demand for funds), Banking Liquidity going higher and is surplus, Banks don't encourage new deposits and the deposit rates are lower too, inflation (non food) has started to move lower from its peak,GOI and RBI gets worried about economic growth in its statements, RBI talks about cutting interest rates, Stock Analysts start revising earnings estimates lower, a global economic slowdown (falling commodity prices) or crisis or risk aversion, Global growth is slowing & Central Banks are cutting rates, your bank starts calling you to take loans etc. Most of these indicators are available freely on the internet.

How to choose a Gilt Fund? I have ignored the normal due diligence on Gilt Funds such as Exit Loads, Expense ratio, other costs etc. The technical factors are as follows:

1. **Track Record:** A reasonable track record (risk adjusted & for at least 3 years) for the fund including the stability of the fund management team. Out performance of the benchmark indices is not a sufficient condition.
2. **The Fund Investment Philosophy:** The Fund house should have a well defined investment processes and team driven decision making. That will make the fund immune to fund manager "style risk" or the risk of the fund manager quitting.
3. **Portfolio Churn:** If you notice rapid and frequent changes in the portfolio composition and weightages from month to month, be a little careful on the fund. It may be generating income from short term trading, which in turn may increase the downside risk. Try and avoid funds which trades more thus increasing the transaction costs.
4. **Average Modified Duration of Portfolio:** Higher the duration (weighted average maturity) of the securities in the portfolio, higher the market risk and vice versa. A high duration fund will do well when interest rates have peaked and vice versa. Most of the Gilt Funds disclose their average month end maturity; though very few debt funds disclose the highest or lowest maturity during the month or even maturities net of hedges, if any.

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5. **Illiquid Securities:** If the portfolio of the fund comprises of illiquid securities, the fund might carry higher risk in form of higher impact cost. The fund may have to resort to fire sales at lower prices to fund large redemptions if any, which in turn may not give the exiting investors the realizable NAV. Fire sales, do hurt the existing investors too. Investors can easily judge the average volumes and liquidity of securities held by the gilt find from www.ccilindia.com.
6. **The Higher Market Risk:** Gilt funds which have higher proportion of their portfolio in GOI securities of maturity beyond 15 years are more risky since it's the most volatile segment of the yield curve, especially when the interest rates rise rapidly. It's a segment characterized by High Risk-High Return.
7. **The economic size of a Gilt Fund:** If the size of the Gilt find is too small the fund manager loses flexibility in managing the fund and it increases the maturity concentration risk. The minimum market lot in the GOI securities secondary market is Rs 5 crs (Face Value).

Why choosing the right Gilt fund is important?

The performance dispersion or range (difference between funds at the top and bottom of returns) in various Gilt funds remains very high. (Table I). This makes the choice of Gilt Funds extremely important to get the desired results. The returns from GOI bonds and Gilt funds have to be looked at from the risk adjusted perspective.

Table I: Returns in % of Medium & Long Term Gilt Funds

	1 year	2 years	3 years	5 years
Top Fund	17.23	15.98	15.69	11.69
Category Average	1.08	6.40	7.62	6.13
Bottom Fund	-4.74	-1.17	2.10	1.29

Source: www.valueresearchonline.com. Data in % as on 17th February 2010

Is it the time to invest in Gilt Funds now, as a tactical allocation? The other way to put this question is “Are yields on GOI Bonds likely to come down?” Even the best of fund managers can't catch the top in the yields, like the bottom in stock markets.

Without getting into the technical matters such as term structure of interest rates (or inflation, illiquidity or other premiums etc) which drive GOI bond yields, let's understand in a very practical manner, what influences GOI bond yields in India.

Let's review the **Negatives (impediments) for the GOI bond yields to move lower** and we have used Donald Rumsfeld, ex defense secretary of USA, quotes on describing risks in a different perspective, the “**Knowns and Unknowns**”.

- └ **Rising Inflation: It's a Known Unknown:** Inflation (WPI) at 8.5% in March 2010, more or less is in the current bond yields and moreover its supply driven. Inflation beyond two digits is a risk now especially if 2010 monsoon fails again.

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Though both authorities are of the opinion that inflation would start receding in 2H CY2010.

- ┌ **RBI stance: It's a Known Known** : We all know that RBI will “normalize” the liquidity in 2010-11, by raising short rates but that does not mean that policy rates and lending rates would rise in equal proportion specially with liquidity as of now is sufficient and India’s output still remains below trend with surplus capacity in some pockets. Moreover monetary transmission from short (RBI driven) to long rates (market driven) on the GOI bond yield curve still remains weak in India. Though it may continue to normalize the liquidity soon, RBI will act in a gradual fashion, to raise the policy rates in order not to abort the recovery process. It will wait for the growth to be balanced; self sustaining and well entrenched before some serious policy rate hikes.

- ┌ **Higher Bank Credit off take: Known Known:** It’s expected that the Bank Credit will recover (more demand for money) as the economic growth firms up across all the sectors. But the fact remains that today only 40% of the total credit requirement for the commercial sector comes from banks, rest are from non banks sources. So even if the bank credit takes off, there will be a marginal impact on interest rates. With RBI discouraging bank investments in mutual fund units, some liquidity has been freed up since then.

- ┌ **Government Borrowing Program higher (2010-11): Known Unknown:** This is a wild card and most important factor as well as the risks for the direction of interest rates in 2010-11, with very little support now from RBIs OMO or MSS (unwinding or de sequestering). And if the borrowing size rises, GOI will need more help from non bank buyers, especially insurance companies and provident funds. But there are chances of a positive surprise in form of lower projected fiscal deficit. That may happen if the GOI initiates fiscal consolidation measures and with help of higher growth, roll backs of duty cuts, better tax/non tax revenues as well as one time revenues such as 3G auctions and Divestments of state run enterprises. On the expenditure side, though defence, subsidies and interest remains “relatively inflexible and politically inelastic”, some of the expenses in last year such as NREGs, arrears of pay revision etc will no longer be a burden in coming year. This will at least maintain or lower the supply of GOI bonds. The 30 bps up move in 10 year GOI Bond Yields since January 2010 when RBI announced a 75 bps hike in CRR, was not due to RBI liquidity normalization, but more due to worries on the 2010-11 borrowing programme and uncertainty on fiscal issues.

- ┌ **World Central Banks hikes rates & US Treasury Yields go up: Known Knowns.** The Global central banks will await the confirmation of a self sustaining recovery to start the exiting form of raising rates etc. The sovereign crisis has already made some of the central banks pause there rate hike actions (Norway, Australia). We all know that the adjustment of global imbalances will be through USD depreciation and rise in US interest rates. And US 10 year yields going at 4.25-4.50% (3.75% now) in late 2010 won't be shocking to any bond market trader. As we write

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this the US Federal Reserve has already upped its discount rate by 25 bps to 0.75%, which is again a normalization move rather than a policy clue.

In all the negative factors referred above there are Known and Known Unknown factors, but there are “**No Unknown Unknowns**” which probably are the bigger risks to GOI bond yields. And we all know that news that is not discounted (known) by the markets have more lasting effects on it, on the either side.

And the positives for the GOI bond yields to remain steady or move lower comes from the lower fiscal deficit targets by GOI in the budget, if Global growth slows (due to early stimulus exits, higher inflation and interest rates) sending negative impulses to Indian growth rate, if Inflation peaks out due to global slowdown and fall in commodity prices and GOI steps on agricultural inflation, an surprise SLR ratio hike or hike in HTM ceiling for banks, if the sovereign crisis in Europe becomes a contagion resulting is risk aversion globally: Unlike Europe, India’s balance sheet remains in good shape.

From the relative asset class valuation (Earnings yield less Bond yield) perspective GOI bonds appear to be more attractive then stocks, especially if they fall more from here. **If some of the above mentioned negatives play out simultaneously in next few months, (especially higher GOI borrowing programme) the GOI 10 year Bond yields may hit 8.35-8.50% or beyond.** That would be good levels to get into Gilt Funds as a tactical exposure and hold on for 2-3 years as a portfolio hedge just in case the world economy falters and the global sovereign risks take an ugly turn. And do watch the Budget for the GOI borrowings and Fiscal consolidation path.

Devendra Nevgi

**Delta Global Partners
Founder & Principal Partner**

deven@dgp.co.in

Tel: + 91 9867 277 977

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