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# Debt Fund is preferred by the Indian Banks

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ABSTRACT

*Investors have either to invest in equity fund or in debt fund. In equity fund, gain to investors depends on performance of the industries registered to stock exchange. Here, gain is directly associated with risk. Investment in debt fund is less risky and gain is almost guaranteed. In general, in this case, the investors invest in government security (G-sec). Risk takers having high income should invest in equity fund and risk averter having fixed and low income should invest in debt fund.*

Keywords : Equity fund, debt fund, expense ratio, risk, Indian banks

**Introduction**
The Indian financial institutions chose debt fund. More than two-third of total collected funds by Scheduled Commercial Banks has been allocated to debt fund. The State Bank of India has allocated most of its fund in debt having low risk and has performed well.

**Literature review**
Mutual fund is the combination of equity, debt and hybrid fund. Equity mutual fund is risk adjusted return in which individual fund does not earn higher returns from following the momentum strategy in stock (Carhart, 1997) because of investment constraints (Almazan, 2004). Restriction on competing products is the reason of the development of money market and short term bond funds (Klapper, 2000). Therefore, an investor should invest in small equity fund whose trading activity is high (Dahlquist, 2000) or whose expense ratio is low ( Malkiel, 1995) . Funds that heavily underperform have very high expense ratio, while funds that are successful do not increase revenues by raising their fees but benefit from increased size of their funds (Elton 1996, Carhat 1997). Actively managed equity funds charge higher fees than index tracking funds or bond and money market funds, reflecting the higher costs of employing investment management staff to achieve diversification and strategy (James et al. 1999). Funds charge lower fees when they have smaller boards and a large proportion of independent directors (Tufano and Sevick, 1997). Larger and more mature funds as well as no load funds have lower expense ratio (Malhotra and Mcleod, 1997). Aggressive growth funds charge higher entry and exit fees to discourage redemption because they hold more of the smaller, less liquid stocks (Chordia, 1996). However, despite the basic academic advice offered to investors to prefer low expense index funds, actively managed funds continue to be popular (Gruber, 1996). To decrease the risk it is advised to use derivative. Bond mutual fund uses derivatives more than equity mutual funds. Use of derivative is negatively correlated with fund age and positively correlated with fund size (Johnson and Yu 2004) and it is positively correlated with asset turnover (Koski and Pontiff, 1999). Derivatives are used for trading rather than hedging (Minton et al. 2009).

**Objective**
To know why the Indian banks prefer debt rather than equity fund?

**Methodology**
Risk (β), expense ratio and NAV (Net Asset Value) has been used in the present study to know the risk and performance of the fund. A case study of Scheduled Commercial Banks (SCB) has been undertaken for the study to know the pragmatic knowledge about the allocation of fund.

A case study of State Bank of India (SBI) has been undertaken for the study to know the pragmatic knowledge about risk.

**Analysis**
The risk and performance of both the debt and equity fund has been shown in table-1 and table-2. Equity fund is highly risk than debt fund. Equity fund gives higher return than debt fund. A comparative performance of debt and equity fund has been shown in table-3. Table-4 and table-5 clearly show that SCB prefers debt fund rather than equity fund to invest. The SCB takes low risk. The Scheduled Commercial Banks (SCB) of India invests more than 80.00 per cent in debt market, as shown as in table-2. Most of the SCB funds were invested in Central Government Securitas (G-Sec). SCB invested two-third of its total funds in G-Sec. Less than 10.00 per cent of its fund was invested in equity funds. Perhaps this is the reason why net profit of SCB increased Rs. 24582 Cr. in 2006 to Rs. 57100 Cr. in 2010.

**Table-1: Risk and Performance associated with SBI Equity Mutual Fund**

| Funds | Risk (β) | Expense ratio | Minimum Investment (Rs.) | NAV | | Sectoral Fund Allocation | |
|---|---|---|---|---|---|---|---|
| | | | | Growth | Dividend | Production | Services |
| Equity | 0.91 | 2.25 | 1000 | 41 | 27.56 | 26.69 | 73.31 |
| Global | 0.94 | 2.08 | 2000 | 53.64 | 27.23 | 45.96 | 54.54 |
| Emerging | 1.07 | 2.25 | 2000 | 42.29 | 16.01 | 32.26 | 67.74 |
| Multiplier | 0.80 | 2.02 | 1000 | 72.95 | 46.08 | 32.33 | 67.67 |
| FMCG | 0.64 | 2.49 | 2000 | - | 33.26 | 0.33 | 99.67 |
| Pharma | 1.02 | 2.49 | 2000 | 45.92 | 37.96 | 98.21 | 1.79 |
| I.T. | 0.99 | 2.49 | 2000 | - | 21.79 | 0.00 | 100 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Contra | 0.94 | 1,86 | 2000 | 48.86 | 16.05 | 39.60 | 60.40 |
| PSU | - | 2.28 | 5000 | 8.35 | 8.35 | 20.79 | 79.21 |
| Arbitrage | 0.49 | 1.84 | 25000 | 14.42 | 12.42 | 7.80 | 92.20 |

Source: SBI Mutual Fund Brochure, February 2012

**Table-2: Risk and Performance associated with SBI Debt Mutual Fund**

| Funds | Risk (β) | Expense ratio | Min Inves tment (Rs.) | NAV CD | | Asset Allocation (%) | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | CP | NCD | G-sec | Other | |
| Ultra | - | 0.33 | 10000 | 1000 | | 65.05 | 27.30 | - | - | 7.65 |
| S.T. | - | 0.63 | 10000 | 10.35 | | 35.86 | 0.77 | 54.47 | - | 8.90 |
| MIP | - | 1.99 | 10000 | 10.33 | | 13.79 | 5.73 | 40.14 | 15.58 | 20.76 |
| Liquid Premier | - | 0.07 | 50 L | 1003 | | 64.42 | 28.74 | - | - | 6.84 |
| Children Benefit | - | 1.54 | 1500 | 23.82 | | 12.24 | - | 43.64 | - | 44.12 |
| Income Plus | - | 1.25 | 25000 | 11.9 | 10.78 | - | - | 49.06 | - | 50.94 |
| Income Magnum | - | 1.30 | 2000 | 11.31 | | 21.31 | - | 28.06 | 29.61 | 21.02 |
| Gilt Short | - | 0.84 | 25000 | 20.9 | 11.27 | - | - | - | 6.76 | 93.24 |
| Gilt Long | - | 1.19 | 25000 | 10.5 | | - | - | - | 57.69 | 42.31 |
| Floater | - | 1.65 | 10000 | 10.47 | | 67.64 | - | 15.08 | - | 17.28 |

Source: SBI Mutual Fund Brochure, February 2012

Note:
(1) Other source of asst allocation includes -Reserve repo, equity Shares, T-bills, Zero Coupon bond, Short term deposit
(2) Production Sector includes automobile, construction, metals, pharmacy, Cement, industrial manufacturing, textiles, fertilizers & pesticides and chemicals

**Table-3: A comparative study of gain between Equity Fund and Debt Fund**

| Issues | Mutual Fund | |
|---|---|---|
| | Equity Fund | Debt Fund |
| Volatility | Highly volatile | Less volatile |
| Gain depends on | Market growth | Government declaration |
| Possibility of no gain | yes | No |
| Possibility of Loss | Yes | No |
| Possibility of very high gain | yes | Lower than equity fund |
| Suitable for | Rich investors | Middle |
| Who should invest | flexible income investor | Fixed income investor |

**Table-4: Investment by Scheduled Commercial Banks (Rs. Cr)**

| Allocation of funds | 2008 | | 2009 | |
|---|---|---|---|---|
| | Aggregate | Per cent | Aggregate | Per cent |
| Central Govt. Securities | 772565 | 66.50 | 920579 | 64.54 |
| State Govt. Securities | 151811 | 13.06 | 229030 | 16.05 |
| Other Trustee Securities | 11557 | 1.00 | 9897 | 0.70 |
| Share and Debenture of Joint Stock Companies | 91498 | 7.88 | 89846 | 6.31 |
| Other investment | 134391 | 11.56 | 176893 | 12.40 |
| Total | 1161822 | 100 | 1426245 | 100 |

Source: Statistical Tables Relating to Banks, RBI

**Table-5: Sources of Earnings to SCB ( Rs. Cr.)**

| Items | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|
| Interest earned | 185388 | 231675 | 308482 | 388482 | 415752 |
| Other income | 35368 | 43041 | 60391 | 75220 | 78519 |
| Interest expended | 107161 | 142420 | 208001 | 263223 | 272084 |
| Operating expenses | 59201 | 66319 | 77283 | 89581 | 99769 |
| Provisions and contingencies | 29812 | 34775 | 40864 | 58147 | 65310 |
| Total earnings | 220756 | 274716 | 368873 | 463702 | 494271 |
| Total expenses | 166362 | 208739 | 285284 | 352805 | 371852 |
| Provisions and expenses | 29812 | 34775 | 40864 | 58147 | 65310 |
| Net profit | 24582 | 31203 | 42726 | 52750 | 57109 |

Source: Statistical Tables Relating to Banks, RBI

**Conclusion**
From above one may conclude that debt fund is able to provide economies to scale benefit to retail investors through minimizing transaction costs and better market accessibility. It pools the retail investor's money which is managed by fund managers to maximize the yields. In this case, the investors do not have to pay transaction and brokerage fees as paid as in demat account. It provides the trained, skilled, well informed professionals who understand the linkages between different markets and its dynamism. Funds manager is able to hedge the portfolios using options and powerful techniques. For the said reasons, Indian banks prefer debt rather to equity fund.

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