Outlook MONEY

Bonding With Bonds: How To Use The Direct Bond Route

Joydeep Sen - 28 December 2021

When it comes to investments in bonds, we think mutual funds (MFs), and for valid reasons. Having said that, investors should be aware of the direct bond route, the advantages it offers and the process of investment.

Though the secondary bond market in India is institutional or wholesale as trades happen in very large lot sizes, there are certain entities, for example, broking outfits or non-banking financial companies (NBFCs), which deal in corporate bonds and make these available in lot sizes that are not as big. Usually, these entities deal in lot sizes fit for high networth individuals (HNIs), but they also cater to the mass affluent segment and some of them, even to the retail segment. One interesting development here is that digital technology is helping broaden the reach of this market as it imparts the convenience of investing at your comfort, without human intervention. The Reserve Bank of India (RBI) Retail Direct Gilt Scheme is definitely a good initiative in this context, but it does not offer corporate bonds.

For clarity, most corporate bonds are listed at the exchange, i.e., the NSE or the BSE, and you can open a trading account with a broker and invest. However, traded volumes at the exchanges are minimal. You may not be able to buy or sell the bond of your choice. Trades happen mostly in the institutional segment, which is not through the exchange trading screen. Moreover, the relevant parameter for investment in bonds is not the price but the yield. This is yield to maturity (YTM) or yield to put/call (YTC/YTP), which is the effective annualised return that you will get, if you buy the bond today and hold till redemption. The quote on the exchange screen will reflect the price of the bond, which is an input for calculation of the yield. You will require the guidance of a bond trader or go through the digital bond trading platforms.

Digital Platforms

While you have to work with a bond house, the process is simpler with digital tech. To understand what these have on the menu, let us take an example: BondsKart.com, promoted by JM Financial. You can download the app or visit the website. Bonds are classified in various categories, from which you can pick and choose as per issuer profile (PSU, G-sec, state development loan or SDL, bank, NBFC, etc.), credit rating (AAA, AA, etc.), maturity tenure with or without put/call, frequency of interest payment such as annual or semi-annual, etc. It shows the YTM of the bond, which is not available on the exchange screen, and minimum investment quantum so that you can pick one as per your lot size. When you want to sell a bond, you can put in your details and request for a quote. There are other similar service-provider websites like Goldenpi.com, indmoney.com, bondsindia.com, inrbonds, etc., which you can check out.

Types Of Bonds

There are multiple types of bonds available in the market; we will discuss a few of them.

Plain Vanilla Bonds

Bonds or debentures carry a defined coupon rate, which is the interest rate you receive. The coupon payment frequency is usually annual for corporate bonds, but it can be any other frequency as well like half-yearly or quarterly. The market price will vary, to adjust the yield (YTM or effective return mentioned earlier) with changing interest rates in the market. As bonds are issued by public sector entities (PSUs), private sector companies, banks, NBFCs, etc., the credit risk is gauged by the credit rating assigned by the rating agencies. AAA is the best, followed by AA, and so on. The coupon or interest rate is chargeable to tax at your marginal slab rate.

Tax-Free PSU Bonds

The basic aspects discussed above remain the same; the coupon or interest rate is free from tax. These bonds are rated AAA, which is the highest credit rating. We mentioned earlier, the way to look at a bond is not the price quoted in the secondary market, but the yield or YTM. For tax-free bonds, there is another nuance. In other (taxable) bonds, your interest receipts are taxable at your marginal slab rate. Hence, for comparison, the yield on a tax-free bond is grossed up at your tax rate. As an example, if the YTM on a tax-free bond is, say, 4.50 per cent, it seems low. However, if your tax rate is, say, 42 per cent, the grossed-up equivalent is 4.50 per cent divided by (1 minus 42 per cent). This means 4.50 per cent divided by 0.58, which is equal to 7.76 per cent. This is far superior to similar credit quality offers in taxable bonds.

Bank Additional Tier I Perpetual Bonds

These are quasi-debt or quasi-equity instruments. In the case of Yes Bank, the entire outstanding quantum of AT1 bonds were written off, but there are better quality banks. There are public sector banks and leading private sector banks, where the risk of bankruptcy is remote, though some risk exists. The rationale is that you get a higher yield over bonds of the same bank, due to the risks in this category of bonds. Though these are perpetual, there is a call option after five years from the issue date, and it is expected that the banks will 'call back' on the call option date.

Building A Bond Portfolio

While building your bond portfolio, do keep in mind that diversification is important; purchase multiple bonds across issuers. You can have various coupon payment dates on these bonds, which will create automatic cash flows.

Liquidity is an issue, but highly-rated corporate bonds can be sold in the secondary market without an adverse impact cost. You will need to execute the sales through bond houses because there is a requirement to scout for buyers since the exchange trading screens do not have much liquidity.

Globally, the bond market is bigger than the equity market, but in India it is the reverse. In India, the bond market is developing, but that also means that there is much scope. Debt investments have certain advantages: returns are more stable than for equity and if you hold a bond till maturity, you are free from market price fluctuations. To make use of these advantages, you can allocate a part of your portfolio to debt, for shorter time horizon cash flow requirements and the relatively stable component of your long-term investments. Start participating; direct bonds are an available option.

The writer is a Corporate Trainer and Author