# Retail Participation in Corporate Bonds through Mutual Funds

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### *Importance of Savings for Economic Growth*

Retail investors or households play a less visible but a vital role in the functioning of an economy not only as factors of production or as consumers but as a source of financing for investment through saving. Economic history suggests that countries that were able to accumulate high levels of domestic investment largely financed by domestic savings achieved faster rates of economic growth, development & less cyclical economic volatility. There are disputes among economists, whether savings actually effect growth in the long term, most notably between Nobel prize winning economist Solow & classical Keynesian such as Harrod-Domar. However, Inter-country experiences with regard to the links amongst savings and growth conclude the positive effect of savings on growth. Over the decades, the secular uptrend witnessed in domestic growth is clearly associated with the consistent trends of increasing domestic savings and investment. As can be seen from the table below, the impressive growth story of India, particularly in the aftermath of reforms seems to have been facilitated by the improvement in the rate of aggregate domestic savings.

**Trends in the Indian Economy (Period Averages)**

| | 1950-1960 | 1960-1970 | 1970-1980 | 1980-1990 | 1990-2000 | 2000-2010 | 2012-2017 |
|---|---|---|---|---|---|---|---|
| Real GDP Growth | 3.6 | 3.9 | 2.9 | 5.6 | 5.8 | 7.2 | 6.9 |
| Gross Domestic Capital Formation/GDP | 11.3 | 14.6 | 17.5 | 20.4 | 24.3 | 31.2 | 34.6 |
| Gross Domestic Saving/GDP | 10.2 | 12.7 | 17.3 | 18.6 | 23.0 | 30.6 | 32.4 |

Source : SEBI

Amongst a range of financing methods, bonds have been an extremely important, durable, and cost-effective source of financing for companies around the world for decades. The market disruptions of 2008 and recent years where public sector banks have de-risked their balanced sheets have underlined the critical role they play in transmitting finance around the world to enterprises in the real economy & help achieve broader economic and public policy objectives.

### *Dominant Role of Household Savings*

As can be seen from the table below of incremental annual savings, it's the Indian household/retail sector which occupies a position of dominance over the other institutional sectors like private corporate sector and the public sector in terms of generating savings & has helped drive growth engine of the economy.

| % share in Gross Savings | 2011-12 | 2012-13 | 2013-14 | 2014-15 | 2015-16 | 2016-17 |
|---|---|---|---|---|---|---|
| Non financial corporations | 28.0 | 29.5 | 33.4 | 35.3 | 39.8 | 41.0 |
| Financial corporations | 9.0 | 8.9 | 8.1 | 8.4 | 6.8 | 7.3 |
| General Government | -5.2 | -4.7 | -4.8 | -4.4 | -3.5 | -2.5 |
| Household sector, of which | 68.2 | 66.3 | 63.3 | 60.7 | 56.9 | 54.2 |
| Net financial saving | 21.2 | 21.8 | 23.1 | 22.9 | 25.2 | 22.5 |
| Saving in physical assets | 45.9 | 43.5 | 39.3 | 37.6 | 29.6 | 30.6 |
| Saving in the form of gold & silver ornaments | 1.1 | 1.1 | 1.0 | 1.1 | 1.1 | 1.1 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

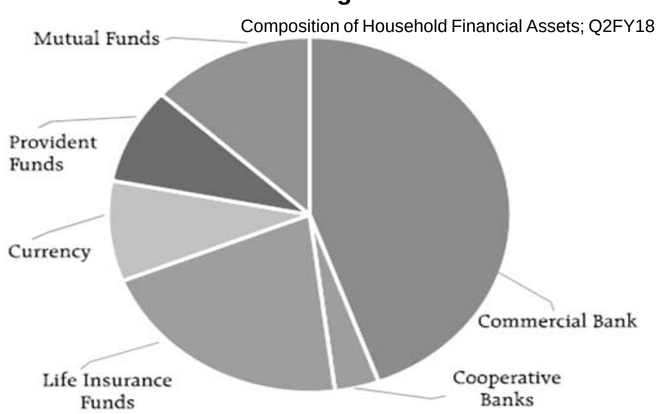
**Comparison between Indian Savings Rate & Global Savings Rate to Financial Assets**

| | HH fin assets (CY2016), % GDP | Gross domestic savings CY2016, % of GDP |
|---|---|---|
| India | 90.0 | 30.0 |
| Australia | 251 | 23.0 |
| Canada | 342 | 20.7 |
| France | 248 | 21.9 |
| Germany | 212 | 27.2 |
| Greece | 219 | 9.9 |
| Hungary | 263 | 29.9 |
| Italy | 310 | 20.3 |
| Japan | 380 | 24.5 |
| Korea | 275 | 36.2 |
| Mexico | 233 | 22.4 |
| Russia | 185 | 29.1 |
| Turkey | 106 | 25.3 |
| United Kingdom | 346 | 15.3 |
| United States | 402 | 16.9 |

Source: OECD, World Bank, IMF, CEIC

Despite having one of the highest savings rate in the world, Indian households hold abysmal amount of financial assets compared to their global counterparts. There is a clear evidence of preference for "predictable" returns when it comes to fixed income whereas higher but volatile returns is sought or tolerated from real estate, equities or gold. The average household holds only 5% in financial assets with 77% of his total assets invested in real estate, 7% in other durable goods (such as transportation vehicles, livestock and poultry, agricultural machinery and non-farm business equipment) & 11% in gold (Source: RBI).

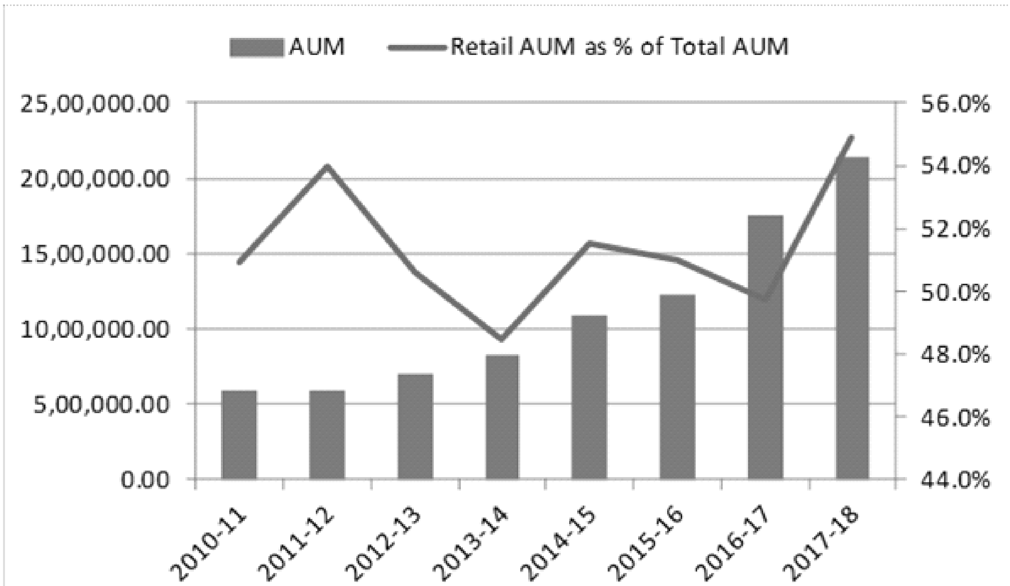
**Composition of Household Financial Savings**



As can be seen above from the composition of household financial assets, , the Indian retail investor prefers to park his money in more predictive return investments i.e. primarily fixed deposit/provident funds with 56% of his financial assets parked between them. Main reason behind this behaviour has been historically high & sticky nominal rates from both fixed deposits & provident funds as banks followed prime rate lending model where both deposit & loan rates remained sticky, irrespective of the RBI rate cycle. Provident fund rates also remained decoupled with market interest rates providing no incentive for retail investors to look for alternates. However, with RBI implementing marginal cost lending rate (MCLR) which has ensured faster transmission of policy rates & with Govt deregulating small saving rates & benchmarking them with market interest rates, retail investors are now increasingly looking at fixed income mutual funds.

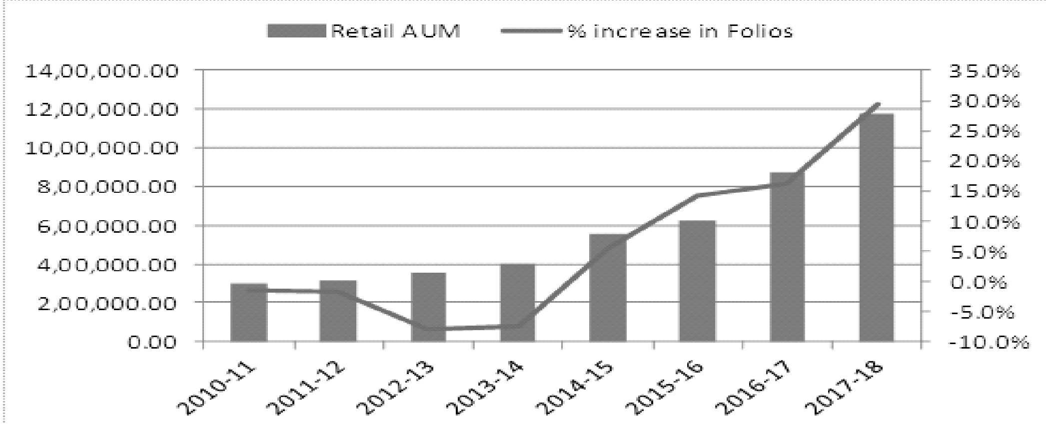
**Growth in Mutual Fund Industry**

The purpose of mutual funds is to bring together investors seeking to provide funds, and participants seeking to use them, matching them in ways that maximise the benefit for both. Mutual funds especially provide a very tax efficient, flexible, and safe mechanism to connect investors to help optimally allocate their portfolios between capital gains (equity) & stable income stream (fixed income). While equity markets are standardised & enjoy high liquidity & hedging mechanisms which makes it easier to replicate even at an individual's level for informed investors, fixed income instruments especially corporate bonds are suitable via MF route as it requires matching of investor's risk appetite to a product i.e. interest rate & credit risk.



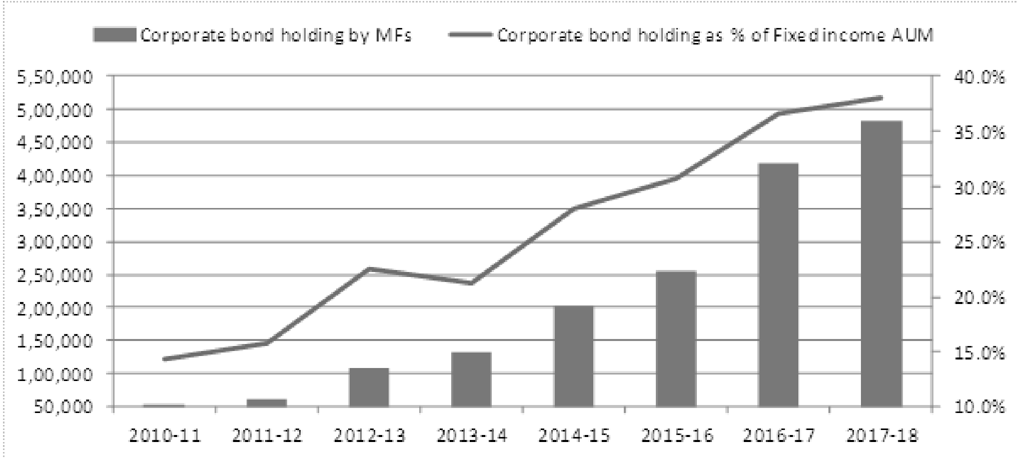
Source: AMFI, Retail AUM is Retail+ HNI

In the last few years the MF Industry has grown significantly due to increasing financial awareness, regulatory initiatives, tax incentives. Demonetisation provided a massive boost to the industry as bank deposit rates fell substantially increasing the appeal of mutual funds. Assets under Management (AUM) of mutual fund industry saw a significant 42% jump of their asset base to 17.5 lakh crores at the end of FY17 from 12.3 lakh crores in FY16 boosted by demonetisation & further grew by 21% to 21.3 lakh crs as at the end of FY18.



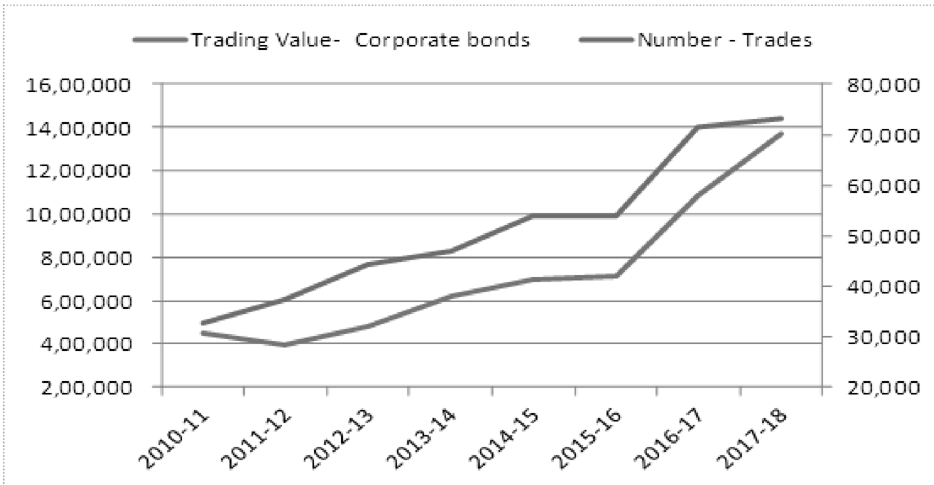
Source: AMFI, Retail AUM is Retail+ HNI

Retail AUM also saw a substantial jump post demonetisation with retail AUM growing by 39% to Rs. 8.7 lakh crores in FY17 & further growing by 34% to Rs. 11.7 lakh crores at the end of FY18. Retail participation has also broadened with 16% & 29% increase in number of retail folios with the MF industry in last 2 yrs.



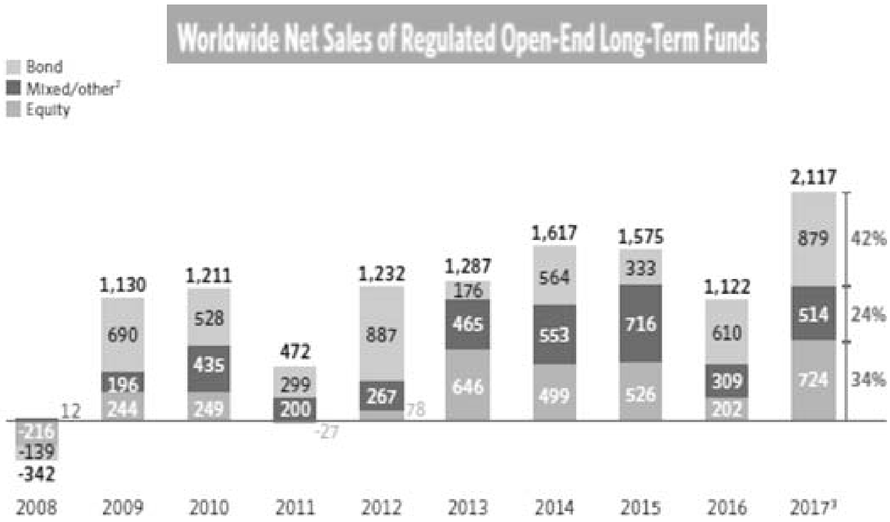

Source: SEBI

The robust flows into fixed income funds have benefited the corporate bond market & helped it grow in size & liquidity. Corporate bonds deployed by mutual funds have grown to Rs. 483,000 crs in FY18 from 53,000crs in FY11 clocking annualised growth of 32%. Growth is visibly stark from 2016 onwards with mutual fund holdings of corporate bonds increasing from Rs. 2.5 lakh crores to Rs. 4.2 lakh crs as on FY17 & share of corporate bonds of fixed income AUM increasing from 14.3% in FY11 to 31% in FY16 & 38% as on FY18 (as can be seen in chart above). This has also helped deepen corporate bond market & given further confidence to retail investors to invest in fixed income mutual funds. As can be seen from the chart below, mutual fund flows have acted as a catalyst for both trading volume & quantum of trades in corporate bonds whose increase correspond to flows into mutual funds post demonetisation. This underscores the importance of promoting mutual funds amongst retail investors which can help deepen bond market & enhance bond market liquidity.




Source: SEBI

**Way Ahead**




Source: Investment Company Institute

Bond funds are increasingly becoming popular globally, particularly for individuals and funds that need stable and predictable income and retention of capital value. In the last 10 years, global bond funds have seen substantial flows & have even exceeded inflows into equities. Demographic trends in the developed economies are making it essential for investors to save appropriately for lifetime financing needs and to reduce reliance on state pensions.

With increasing awareness, Indian retail investors are incrementally looking towards fixed income funds (both open ended & closed ended- fixed maturity plans) as fixed income mutual funds have now demonstrated a long track record of delivering healthy post tax adjusted returns with portfolio liqudity. As investors re-balance their portfolios, we can continue to expect increasing allocations in favour of fixed income mutual funds compared to fixed deposits. Bonds offer relatively secure real post tax returns, potentially higher than from bank deposits, but with more predictable investment income and capital security than is available with equities. As such they assist efficient investment of savings, particularly for investors needing to generate income especially those who are not fully covered by social safety nets such as pension/provident funds.

Increasing the liquidity & depth of bond market has been a major agenda for the Government and RBI for long. The Indian debt market has historically been restricted to a small set of institutional & foreign investors majority of whom are driven by broadly similar rate expectations.

Various efforts in the forms of reforms, change in guidelines and making availability of the required infrastructure has been made in the direction but still the corporate bond market is relatively illiquid to its G-Sec counterpart. Regulators have taken much needed reforms for inter-bank markets like introduction of masala bonds, corporate bond repo, credit enhancement of bonds, REIT/Invit simplification to enable wholesale market in the recent years.

Regulators can encourage more retail involvement in corporate bonds especially through mutual funds as mutual funds have the wide range of products across duration as well credit segments to cater to different investor needs & provide most efficient price discovery, liquidity for the markets. Thanks to efforts of the regulator, mutual funds are the cheapest, liquid & most transparent financial product available to retail investors with a credible benchmark.