

Calendar year 2025 has delivered sharply divergent outcomes across asset classes. Equity markets produced low single-digit returns; debt delivered only moderate gains despite an easing interest-rate environment, while gold and silver prices surged dramatically. This wide dispersion in returns has challenged traditional portfolio construction and reinforced a critical question for investors: how should asset allocation adapt when correlations across asset classes become volatile and unpredictable.

In such an environment, diversification is no longer a passive exercise. Instead, it has emerged as an active portfolio management tool one that not only provides stability during periods of uncertainty but also creates opportunities to rebalance allocations in response to evolving market conditions.

Renewed Focus on Debt as an Asset Class

Debt has gradually regained attention among investors seeking stability, income, and diversification. The primary avenues for debt allocation in India continue to be government savings schemes, bank fixed deposits and debt mutual funds. Among these, debt mutual funds have faced the greatest headwinds in recent years.

The removal of indexation benefits in March 2023 marked a turning point for the category. Since then, inflows into debt funds have remained subdued, driven by the perception of reduced tax efficiency. At the same time, rising equity market participation has further diverted investor attention away from debt, increasingly positioning debt mutual funds as a predominantly institutional product.

Despite these challenges, the long-term relevance of debt mutual funds remains intact. The key hurdle lies in rebuilding retail confidence through sustained and structured investor education.

A Complex Monetary Policy Backdrop

Calendar year 2025 was eventful from a monetary policy standpoint. To support economic growth amid benign inflation, the Reserve Bank of India reduced the repo rate by cumulative 125 basis points. Complementing this move, the RBI also cut the Cash Reserve Ratio (CRR) to facilitate smoother transmission of lower policy rates.

Debt Mutual Funds: Reclaiming Relevance in a Shifting Asset Allocation Landscape



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However, liquidity management proved challenging. Credit growth continued to outpace deposit growth, pushing the credit-deposit ratio higher and limiting the RBI's ability to maintain surplus liquidity. Additionally, foreign exchange interventions aimed at managing rupee volatility led to an unintended drain on domestic liquidity.

To alleviate seasonal pressures, particularly those arising from December tax outflows, the RBI announced open market operation (OMO) purchases to support banking system liquidity. Meanwhile, uncertainty around delayed trade deal announcements triggered further foreign exchange (FX) outflows, adding upward pressure on Government securities (G-Secs) and State Development Loan (SDL) yields.

The combined impact was a pronounced steepening of the yield curve, most evident at the long end. Increased issuance by State Governments, coupled with muted investor demand, pushed spreads wider and reshaped return opportunities across the fixed-income landscape.

The Divergence Between FD Rates and Bond Market Yields

While bank fixed deposit rates have moved lower in line with repo rate cuts, yields on short-term money market instruments and medium- to long-duration bonds have remained elevated. This divergence has resulted in a distinct opportunity set within debt mutual funds. Investors should note that debt mutual funds differ in terms of risk, liquidity, and suitability.

What the Yield Curve Is Signaling

The current yield curve reflects a market grappling with liquidity constraints, elevated term premiums, and ongoing uncertainty. Short and medium-term yields remain attractive and offer compelling carry while limiting exposure to duration risk.

In the current environment, traditional investment options may provide certainty, while debt mutual funds offer flexibility through active management that can adapt to evolving rates and liquidity conditions.

Why Debt Mutual Funds Still Deserve a Place in Portfolios

Despite the loss of indexation benefits, debt mutual funds continue to offer relative return efficiency. Taxation is deferred until redemption, allowing compounding to work on gross returns, and fund managers retain the flexibility to actively manage duration and credit exposure.

More importantly, debt mutual funds play a critical role beyond pure return generation. They act as portfolio stabilizers, provide liquidity for tactical rebalancing, and support short to medium term financial goals with lower volatility compared to equities. Investors should note that debt funds carry risks such as interest rate movements, credit quality, and liquidity.

The Role of Debt in Asset Allocation Today

In an environment marked by uncertainty and volatile macro signals, debt allocation has become increasingly important not just for income, but for diversification and risk management. Thoughtfully deployed, debt mutual funds may enhance portfolio resilience while offering competitive risk-adjusted returns.

The opportunity today lies not in abandoning debt, but in understanding it better and using it more strategically within a diversified portfolio.

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

