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SDLs ARE CONSIDERED NEARLY AS SAFE AS G-SECS

Debt funds flock to state bonds

ANUPREKSHA JAIN
Mumbai, January 14

DOMESTIC DEBT FUND managers have increased their exposure to state development loans (SDLs), as they fetch them higher yields compared with central government bonds and corporate bonds, said debt fund managers. In fact, some are even swapping central government securities with these bonds. SDLs are bonds issued by state governments to fund their fiscal deficit.

1 Currently, the spread between 10-year SDLs and the benchmark 10-year central government bond is 38 basis points. Given the high spread, fund houses like Axis Mutual Fund have even launched state-loan-dedicated funds.

According to industry estimates, mutual funds bought around ₹3 lakh crore of SDLs in FY25, approximately 10% higher compared with FY24. However, it is still lower than pre-Covid levels as borrowings from states have gone down, said industry experts.

"Spreads are quite attractive as they (states) usually borrow less than the notified amount, which makes them more attractive. As far as corporate bonds are concerned, they are illiquid as compared to SDLs, which are quasi sovereign in nature, making them (SDLs) more appealing to investors," said Marzban Irani, chief investment officer – debt, LIC Mutual Fund.

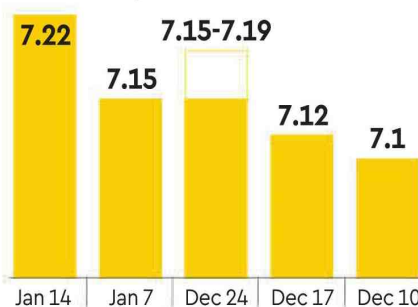
The recent interest in SDLs has also been attributed to an increase in supply in the last quarter of the current financial year. "SDLs are giving yields equivalent to corporate bonds, and for us, it has a statutory liquid ratio (SLR) status. So, if I have to take either a rate call or

IN HIGH DEMAND

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Yield on 10-year SDL



10-year govt bond yield (%)



Source: Bloomberg

maintain my SLR, inclination will automatically be towards SDL as they are giving me higher yields than corporate bonds," said Akhil Mittal, senior debt fund manager at Tata AMC.

Further, SDLs have been trading higher than 'AAA' public sector undertaking (PSU) corporate bonds for maturities of above 10 years and beyond. "A significant part of investments has moved away from corporate bonds to SDLs. More or less, SDLs will perform in line with the broader direction, but our mutual fund flavour towards SDL will continue to remain as they are fetching the same yield..."

"From a credit risk perspective, SDLs are superior to corporate

bonds as they are quasi-sovereign in nature. Not just longer tenure, but even shorter-tenure SDLs give higher yield than corporate bonds, because SDLs are quoted on a biannual basis. Meanwhile, yields on corporate bonds have been compressing because of lower supply from corporates, especially PSUs, on the longer end. And when it comes to liquidity, SDLs are more liquid than corporate bonds," said Avnish Jain, head – fixed income, Canara Robeco Asset Management Company.

Latest SDL auctions have shown average yields of around 7.11% for longer tenures, climbing to 7.23% in annualised terms. AAA-rated PSU bond yields for similar maturities are trading slightly lower, between

7.10% and 7.16%. This mismatch in prices are largely driven by supply, timing, mismatches in fund flows and rising global interest rates. SDLs, issued by state governments and managed by the Reserve Bank of India, are traditionally considered nearly as safe as G-Secs.

SDL issuances, concentrated in the second half of the financial year, have coincided with rising US Treasury yields and a weakening rupee. These factors have tightened domestic monetary conditions, pushing yields higher across the board. Despite these challenges, SDLs continue to attract a strong interest from institutional investors, who view them as a low-risk option with attractive returns.