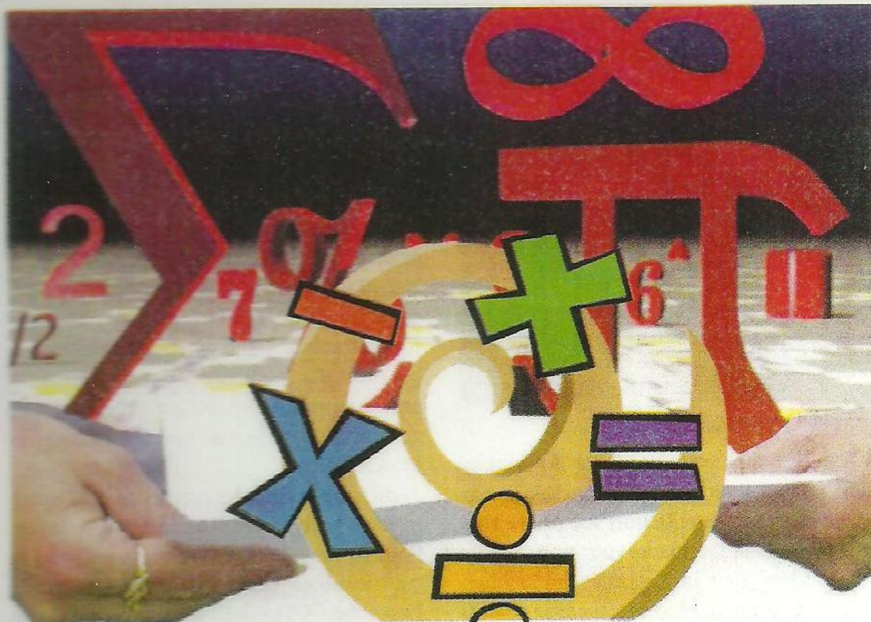


Debt

Making the right choice

Though return from available instruments may be similar, each product is unique for different categories of investors

Investing in a fixed-income instrument is many times mistaken as an easy decision compared with options like equities, real estate, and commodities. Fixed-income avenues offer a higher degree of clarity on return, but investment decision could be difficult at times, especially as there are various investment options in the category. Many times investors assume that all products are similar and invest in any fixed-income product that come their way.

For instance, fixed maturity plans (FMPs) and bond funds are considered similar products. Most investors confuse them with each other. Though the return from available debt products may be similar, each product is unique. Due to some small but significant differentiating features, different debt products are suitable for different categories of investors.

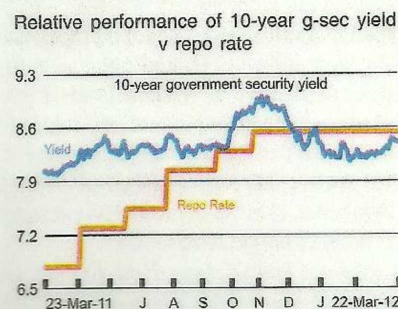
Debt products give the best yields when interest rates are at their peak. The current times, thus, may be the right time to invest in debt products as there are slim chances of interest rates going up any further. Eventually, interest rates are expected to come down. What are the fixed-income options available to investors?

Fixed deposits (FDs) in banks can currently fetch a return of more than 9% per annum. Investors looking beyond banks can get a better deal on AAA-rated FDs of companies. Though FDs are the least complicated of the debt products, they are often not preferred due to the low post-tax yield. As interest from FDs is added to the income of the investor, investors paying tax at the highest rate may not find the returns from FDs attractive. FDs are suitable for those who seek 100% capital protection and do not qualify to pay taxes or pay taxes at a lower rate. Currently, the rates on FDs are quite attractive. Thus, investors can lock in their funds in FDs at the prevailing rates for two to three years.

Timing the market

Debt products give the best yields when interest rates are at their peak. The current times, thus, may be the right time to invest in them

Relative performance of 10-year g-sec yield v repo rate



Figures in percentage

Banks are offering good flexibility for FDs below maturity of one year. SBI and Corporation Bank have removed the premature withdrawal charges on FDs up to duration of one year. Investors who need the flexibility can opt for such FDs but those who do not mind locking up funds for the extra 1%-2% can chose highly-rated FDs of corporates.

Liquid funds allow investors to take exposure to money market instruments and short-term debt paper issued by banks and corporates. Therefore, the risk involved in such funds is quite low. The returns from liquid funds depend on two factors. First, the prevailing interest rates and, second, liquidity. Currently, both interest rates and liquidity are in favor of investors. Interest rates are near their peak and liquidity, too, is quite tight. Due to this, liquid funds can give returns on par with long-term debt instruments. But investors with longer-term horizon should not invest in liquid funds because if interest rates soften and the liquidity position improves, the returns on liquid funds will also fall. Thus, liquid funds may look attractive in the current scenario but yields may drop in future.

Investors can withdraw any fraction of their investment on any working day from liquid funds without any charges. The amount is credited in the bank account on the next working day. Any short-term gains from liquid funds are added to the investors' income and taxed at the rate applicable to the investor. If held for more than one year, the gain is classified as long-term capital gain and investors can pay a tax of 10% without indexation on the overall gain or 20% tax after taking the benefit of indexation. In the dividend option, the fund passes on the gain in the form of tax-free dividend after deducting a dividend distribution tax (DDT) of 27.68%.

Investors looking to earn dividend income can chose ultra short-term funds instead of liquid funds as the rate of DDT on ultra short-term funds is 13.84%. Ultra short-term schemes may attract exit load if

the investment is liquidated before 1-15 days from the investment date. The period differs from fund to fund.

Fixed Maturity Plans, popularly known as FMPs, too, are good investment bets for investors who do not want to hedge their interest-rate risk. As the maturity of the underlying investment portfolio of FMPs and the maturity of the FMP is similar, investors do not face interest-rate risk if they hold FMPs till maturity. FMPs with horizon of one year offer tax-efficient returns compared with bank FDs though the pre-tax rates may be similar. Income from FMPs held for more than one year are classified as long-term capital gain. Thus, investors can get away by paying 10% tax without indexation or 20% tax on the gain adjusted to the indexed value of the investment. Individual investors can opt for dividend and take home the gain in the form of tax-free dividend after adjusting the overall return to DDT of 13.84%.

FMPs are illiquid till maturity. The only exit route for investors is to sell the units on the stock exchange as all FMPs need to be compulsorily listed. But the FMP volumes on the stock exchange is almost zero. As a result, investors get stranded with their investment without any exit route. Thus, investors should keep in mind that they will have to hold on to the investment in FMPs till maturity if they want the extra post-tax returns.

On offer

Top performing debt schemes launched in 2012

SCHEME : SCHEME	CATEGORY	LAUNCH DATE	FACE VALUE (Rs)	LATEST NAV (Rs)	LATEST CORPUS* (Rs)	1 MONTH ABSOLUTE RETURNS(%)
IDFC FMP - Qrtly Series 69 (G)	FMP	17-Feb-12	10	10.09	160.33	0.89
Religare FMP - Sr.XII - Plan D (G)	FMP	08-Feb-12	10	10.11	59.17	0.86
DSP BR FMP - Series 33 - 3Mth (G)	FMP	09-Feb-12	10	10.11	280.71	0.86
Religare FMP - Sr.XII - Plan B (G)	FMP	24-Jan-12	10	10.14	54.49	0.85
UTI-FMP - Qrtly 0212 (G)	FMP	01-Feb-12	10	10.13	67.96	0.83
DSP BR FMP - Series 30 - 3Mth (G)	FMP	17-Jan-12	10	10.18	88.62	0.83
Reliance Fixed Horizon - XXI - Sr.7 (G)	FMP	31-Jan-12	10	10.14	60.8	0.83
Pramerica Short Term Floating Rate Fund (G)	FRF - ST	07-Feb-12	1000	1012.24		0.83
Indiabulls Ultra Short Term Fund (G)	USTF	05-Jan-12	1000	1021.36	536.57	0.82
IDFC FMP - Qrtly Series 68 (G)	FMP	13-Jan-12	10	10.18	62.34	0.82

*As on 29 February 2012. FMP: Fixed maturity plans. FRF: Floating rate funds. USTF" Ultra short term funds

Interest rates and bond prices are inversely co-related with each other. As interest rates go down, bond prices on the stock exchanges go up and vice versa. **Long-term bond funds** generally invest in listed long-term corporate bonds and gilt funds in government bonds. As interest rates have peaked, long-term bond funds and **gilt funds** present an investment opportunity. When interest rates soften, the NAVs of these funds will rise as the value of the underlying portfolio will appreciate. Thus, investors can get into such funds at the present level to gain from the expected slide in interest rates.

The tax treatment for long-term bond funds and gilt funds is similar to that for FMPs. If the investment in such funds is withdrawn before one year, any gain will be added to the income of the investor and taxed at the applicable tax rate.

Long-term bond funds and gilt funds offer high liquidity. But most funds charge exit load of 0.25% to 1% for quitting before three to six months. Smart investors time the interest rate cycle to make a quick buck from such funds and do not mind paying the exit load.

Floating rate funds are not recommended when interest rates are expected to come down. These funds typically invest in floating rate debt papers, whose coupon rates are linked to some benchmark like Mumbai inter-bank offer rate (Mibor), a consensus rate at which banks are likely to lend or borrow for a very short period every day, or the lending rate (repo) of the Reserve Bank of India. As coupon rates float, these funds do not carry interest-rate risk. When interest rates come down, the overall returns from floating rate funds are bound to dip. Investors in such funds should shift to FMPs, long-term bond funds or liquid funds depending on their risk appetite and investment horizon. Such funds are suitable when interest rates are on the upmove.

Floating rate funds offer good liquidity. Investors can exit anytime. These funds do charge exit load. They attract tax treatment just like any other debt fund. At a time when equity markets have turned volatile and medium- to long-term visibility of the Indian and global economy is uncertain, debt instruments can offer a temporary shelter.

— Rahul Mantri

Different options

How various debt instruments compare

INVESTMENT AVENUE	LIQUIDITY	INVESTMENT HORIZON	TAXATION
Fixed Deposits	Low*	15 days to 3 years	Interest received taxable in the hands of the investor and is taxed at the applicable rate
Liquid Funds	Very High	1 day to 3 months	In growth option, gains are taxed at the rate applicable to the investor. Dividend is tax-free in the hands of the investors but DDT of 27.68% is paid by the fund house, which is adjusted in the final dividend amount.
Ultra Short-Term Funds	High^	1 day to 3 months	In growth option, gains are taxed at the rate applicable to the investor. Dividend is tax-free in the hands of the investor, but DDT of 13.84% is paid by the fund house, which is ultimately adjusted in the final dividend amount.
FMPs	Lowest	3 months to 3 years	Long-term capital gain is taxed at 10% without indexation or 20% with indexation. Dividend is tax-free in the hands of the investor but subject to DDT of 13.84%. Short-term gain is taxed at the rate applicable to the investor
Long-Term Bond Funds	High^	6 months to 3 years	Long-term capital gain is taxed at 10% without indexation or 20% with indexation. Dividend is tax free in the hands of the investor but subject to DDT of 13.84%. Short-term gain is taxed at the rate applicable to the investor
Floating Rate Funds	High^	1 month to 2 years	Long-term capital gain is taxed at 10% without indexation or 20% with indexation. Dividend is tax free in the hands of the investor but subject to a DDT of 13.84%. Short-term gain is taxed at the rate applicable to the investor

* Some banks offer good liquidity
^ Liquidity is high but subject to applicable exit load