Liquid funds

A better option

Flexibility of savings account, higher returns and tax efficiency in the highest bracket

Early May 2011, the Reserve Bank of India (RBI) raised interest rates on savings bank account to 4% from 3.5%. The move not only indicated a higher interest-rate regime but also was seen to address the liquidity crunch in the system. Liquidity in the financial system is tight and the RBI wants people to deploy cash in hand into the banking system, thus improving the overall liquidity.

A savings account is considered as one of the most popular avenues to park money because of the primary reason of liquidity. Maintaining sufficient bank balance is a good habit but keeping more than the required amount means loss of opportunity to earn extra return. Is there any product, that gives liquidity along with returns above the savings bank rate? The answer is yes. Cash funds, or liquid funds as they are popularly known, are the best option in a situation when the need for liquidity is high and the risk appetite is low.

Liquid funds invest in various fixed income instruments such as treasury bills, certificates of deposit, commercial paper and call money markets. Most of these instruments have a very short maturity. These instruments are out of reach of common investors as the funds required to invest in them is large. Thus, investor can access these avenues through liquid funds and get decent returns on their investments over a short duration.

Low risk

The risk in liquid funds is the lowest among debt funds. Typically, debt funds face two types of risks: interest rate risk and the risk of default by the issuer of the instrument. As the maturity of liquid funds is very short, the interest rate risk is quite negligible. Also, if investment is done in highly rated paper, the risk of default is very low term.

The minimum amount that can be invested in liquid funds varies from Rs 5000 to as high as Rs 1 lakh. Investment can be made even for a single day. This is possible as there is no entry and exit load in liquid funds. Investors can redeem the invested amount even on the next working day from the date of investment. Like any other mutual fund, investors can approach any mutual fund advisor or the asset management company (AMC) directly to obtain the application form. But redemption is settled on a T+1 basis. So redemption request should be made at least one day in advance to receive the payout cheque on the day it is required.

Investors can also opt for direct credit into the bank account. This will reduce the time required for clearance of the cheque. But all AMCs may not offer such direct credit facility. Also, the direct credit facility may depend on the bank of the investor. Most AMCs offer direct credit facility if an investor holds an account with a private bank. Also, if the facility of direct credit is not available due to any reason, the payout cheque is couriered to the investor, which may delay the process of converting units into cash by a couple of days.

Now let's check the gains of investing in liquid funds instead of keeping cash idle in a savings account of a bank. Top performing liquid funds have given a return of 7% to 7.3% for a one-year period till 15 April 2011. Returns have been in the range of 4% to 4.2% on an absolute basis over the last six months. This is far higher than the returns from a traditional savings bank account, which presently stand at 4% per annum.

Apart from higher returns, liquid funds are more tax efficient if the investor falls in the highest tax bracket of 30%. Investors can opt for dividend option and get away by paying tax of 25% instead of 30%. If investors fall in the lower tax slab, they can opt for the growth option and pay tax at the rate applicable as per their total taxable income. Investors holding units for more than one year can also get indexation benefit, thus pruning down their tax liability substantially.

Liquid funds are often used to park money for systematic transfer plans of mutual funds. The systematic transfer plan works well if an investor has a lumpsum amount but wants to invest systematically to counter the volatility in the equity markets. Investing the available amount in a liquid fund and transferring a fixed amount to an equity fund is a better option than transferring from a savings bank account as the returns on the funds parked in a liquid fund are higher than the returns on a savings bank account.

So next time you have a sizable amount in your bank, even for a short period, opt for liquid funds.

— Rahul Mantri

The alternative

Top 10 liquid schemes by one-year return

SCHEME NAME	LATEST CORPUS (Rs Cr)	MAX EXIT LOAD (%) (NUM)	EXPENSE RATIO (%)	BASE NAV	1-MNT ABSOLUTE (%)	6-MNT ABSOLUTE (%)	1 YEAR CAGR (%)
Escorts Liquid Plan (G)	31.6167	0.00	0.50	15.1262	0.8911	4.8152	8.6247
IDFC Ultra Short Term Fund (G)	623.5700	1.00	0.37	13.7336	0.8681	4.6218	7.8736
Sahara Liquid - Variable Pricing (G)	36.9547	0.00	0.60	1820.3816	0.7388	4.3998	7.5433
Sahara Liquid - Fixed Pricing (G)	36.9547	0.00	0.60	1805.4937	0.7319	4.3595	7.5018
Quantum Liquid Fund (G)	23.5139	0.00	0.45	14.1688	0.7280	4.0798	7.3841
JM High Liquidity Fund - (G)	3170.0545	0.00	0.20	27.1436	0.7266	4.1425	7.3332
Baroda Pioneer Liquid Fund (G)	1769.4900	0.00	0.36	1726.7021	0.7244	4.0677	7.2726
Reliance Liquidity Fund (G)	13113.0000	0.00	0.21	14.9817	0.7187	4.1293	7.2297
Daiwa Liquid Fund (G)	506.7598	0.00	0.24	1111.7683	0.7192	3.9587	7.1903
JPMorgan India Liquid Fund (G)	1141.9300	0.00	0.55	11.8213	0.7011	3.9619	7.1605

NAV and returns as on 01 June 2011. *Source: NAV Inda*