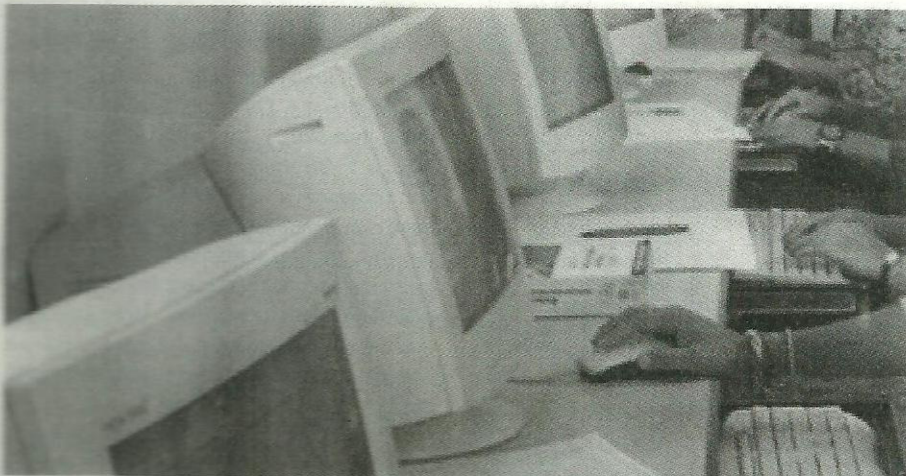

FMPs

A fixed term trap

Fare poorly on liquidity despite a host of benefits compared with other fixed income options

Fixed income investment avenues were out of favor among investors in 2010 when interest rates were soft due to enough liquidity in the money market. The easy money policy opted by the Reserve Bank of India (RBI) too kept interest rates languishing at lower levels. Stock markets were rising consistently, which kept investors interested in the equity markets. Valuations, too, were reasonable during the first nine months of 2010. As inflation was rising, the real rate of return was on the negative side for most of the year. Thus, overall, there was hardly any incentive for investors to go for fixed income instruments.

But as 2011 came closer, the RBI took measures to control inflation by raising policy rates. It continued to hike key interest rates even in January 2011. Higher inflation and tight liquidity propelled the interest rates higher. Foreign institutional investors pressed the sell button as they thought that higher interest rates and commodity prices would affect the profitability of corporate India. This led to a selloff in the equity markets. Suddenly fixed income became the flavor of the season. Fixed income instruments looked attractive as banks and other finance companies raised their deposit rates in line with RBI's hike in key policy rates.

One debt product that has hogged the limelight was fixed maturity plans (FMPs). FMPs are favorite investment avenue for high networth investors (HNIs) because of their tax efficient returns. Classification of gains from FMPs with maturity over one year as long-term capital gain makes FMPs a most sought-after product among savvy investors. As gain from FMPs is classified as long-term capital gain, investors in FMPs get indexation benefit for units sold after holding for more than one year. Thus, if an investor invests in a 15-month FMP in February 2011, he gets indexation benefit for two financial years as his holding is spread across two financial years, i.e., 2010–11 and financial year 2011-12. This makes returns from FMPs virtually tax-free, making FMPs a very attractive proposition. Generally, FMPs provide far superior post-tax returns than other fixed income products like fixed deposits (FDs), bonds and debentures if the investor falls in the highest tax slab as returns equivalent to the indexation benefit is exempt of taxes *(see table: How they stack up)*.

How they stack up

Post-tax returns from FMPs and bank deposits in the highest tax slab

PARTICULARS	FMPs	BANK DEPOSITS
Return for one year on investment of Rs 100	9%	9%
Indexation benefit	5%	Nil
Taxable income	4%	9%
Tax	1.2%	2.7%
Post tax returns	7.8%	6.3%

Tax rate is assumed at 30%

Also, for resident Indians investing in FMPs, there is no tax deduction at source (TDS) applicable irrespective of the amount unlike FDs where any interest received over Rs 5000 is liable for TDS (Rs 10000 on interest from bank FDs).

FMPs offer a host of benefits compared with other fixed income options. But FMPs fare poorly compared with other fixed income on liquidity. Earlier, investors in FMPs had an option to exit at prevailing NAVs through redemption from the asset management companies (AMCs). But now it has been made mandatory for AMCs to list the FMPs on the stock exchange. Against this backdrop, AMCs have closed the option of redemption. Thus, investors are forced to sell their units on the stock exchange if they wish to liquidate their units. Though prima facie this option may look better than paying an exit load of up to 2% for premature redemption, the fact is very different.

Though FMPs are listed on the stock exchange, there is virtually zero volume on the bourses. As there are no buyers, investors are left stranded with no exit option. Thus, investors may have no other choice but to hold units till maturity to get investment back. As there are almost no trades in the FMP category on the bourses, smart buyers may take advantage of and buy units at a steep discount to market price. Thus, investors may have to exit at a substantial loss in case of emergency.

The only hope for investors who need funds urgently is opting for a loan against their units. Typically, banks provide 50-60% loan on units of open ended mutual funds. Being a closed ended product, not many banks will offer loan against FMPs. If at all any bank decides to fund against FMPs, the margin requirements will be higher and so would be the interest rates.

Thus, investors should be cautious while investing in FMPs. They should make sure that they will not require the money before the date of maturity. Investors who may require funds before maturity may invest in long-term debt funds as they provide similar tax-efficient returns if held for more than one year. But long-term debt funds are prone to interest-rate risk, which is negated in FMPs, which are close-ended.

— Rahul Mantri