SWATANTRA

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Among Fixed Income Investments, Debt Mutual Funds Score High

Duration funds, credit opportunities funds carry slightly higher risks but can give superior returns

Partha Sinha | TNN

In the last one year, except for a select few sectoral funds and small cap funds, not many of the equity funds have given great returns. On the other hand, debt funds have done relatively well in terms of returns. So far in the new year too, the stock market has been extremely volatile, pushing investors to look for safer havens. In this context, debt funds are looking safer bets for those investors who do not have the appetite for higher level of volatility.

> "Investors who want to invest in duration and credit opportunities funds should look at the experience and expertise of the fund management team and also their processes,"
> **Jignesh V Shah**

Investors who look for a regular income stream, also look at fixed income products like debt funds, bank fixed deposits and post office monthly income schemes. "Among the fixed income products, debt funds score over others because of chances of higher return, has nearly similar level of risks and liquidity," said Jignesh V Shah, president, South Gujarat IFA Association. According to Shah, people looking for regular income could opt for a systematic withdrawal plan (SWP) in debt funds, which, if done judiciously could also save on taxes.

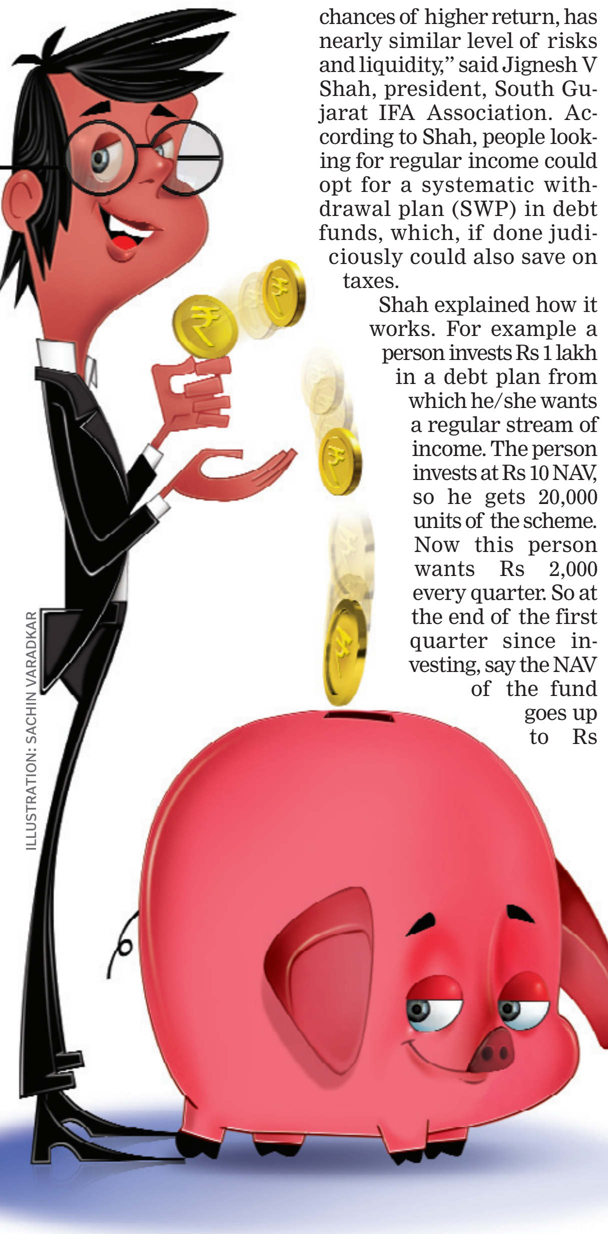


ILLUSTRATION: SACHIN VARADKAR

Shah explained how it works. For example a person invests Rs 1 lakh in a debt plan from which he/she wants a regular stream of income. The person invests at Rs 10 NAV, so he gets 20,000 units of the scheme. Now this person wants Rs 2,000 every quarter. So at the end of the first quarter since investing, say the NAV of the fund goes up to Rs 10.05. At this NAV, if the person withdraws 199 units, he/she will get nearly Rs 2,000. Now if this is done every quarter, the person can get a regular income.

Now if the person invests Rs 1 lakh and goes for a similar SWP three years after investing, the burden of paying tax on the gains that had accrued to him/her will be minimal. This is because the person will enjoy the benefits of long term capital gains and will have to pay a tax of just 10% if he/she doesn't want to avail of indexation, Shah said. In case the person wants to take benefit of indexation, then he/she will pay 20% tax after indexation benefits are availed of.

Shah also suggested two specific types of debt funds for fixed income investors, but warned that these schemes carry slightly higher amount of risks. These are duration funds and credit opportunities funds.

Duration funds are those in which the fund managers take a call on the rate of interest in the market, and hence yield on bonds in his portfolio, and try to maximum return. Since the yield on a bond is inversely proportional to the price, the fund manager takes a call on yield and tries to maximise returns.

On the other hand, in credit opportunities fund, the fund manager would look for companies in which there is a chance for a credit rating upgrade, which will lead higher price of bonds issued by that company and hence to a fall in yield for the same bond. If the fund manager can buy such bonds cheap and sell after credit rating goes up, he/she can give higher returns to investors in the fund.

"Investors who want to invest in duration and credit opportunities funds should look at the experience and expertise of the fund management team and also their processes," Shah said. "IFAs can play a very important role in fund selection for investors," he said.

GURU SPEAK

> Twenty years in this business convinces me that any normal person using the customary three percent of the brain can pick stocks just as well, if not better, than the average Wall Street expert

Peter Lynch, *celebrated fund manager*

NEXT EDITION

In our January 26 edition of Swatantra we will deal with the basics of SIP and how investors can use SIPs in various types of funds to meet their financial goals.

Invest in a judicious mix of good equity schemes

CASE STUDY

I am 29 years old. I have to invest for the marriage and education of my daughter (5 years old). How much should I invest since my budget is Rs 10 lakh for marriage and Rs 15 lakh for education? Will the maturity amount be taxable? Will there be any charge on maturity amount? Are SIPs tax free? Some people say that as per one's age, investments should be divided into equity and debt (100 – your age). Should I follow the same?
Harish Pal, *via email*

Nirav Panchmatia replies:

You will need money for your daughter's higher education when she is about 18 years old and for her marriage when she is about 24 years, with the current cost for her education and marriage at Ts 10 lakh and Rs 15 lakh respectively.

Accordingly, at 7% annual rate of inflation, the future cost comes to Rs 24.10 lakh for higher education and Rs 54.25 lakh for her marriage, respectively.

Accordingly each month you have to invest about Rs 5,750 for your daughter's education and Rs 5,150 for her marriage. Alternatively, today you can make a one time investment of Rs 4.65 lakh and Rs 4.90 lakh, respectively, to achieve the two financial goals for your dughter. Thus either with a Rs 10,900 monthly SIP or with a one time investment of Rs 9.55 lakh, your goals could be achieved. Here we have also assumed a 13.50% per annum compounding rate of return for your investments. For this our advice is you invest in diversified equity mutual fund schemes. This is because the traditional mode of investments like bank FDs or PPF can not compound your wealth at this rate.

TAXATION ETC.: Equity mutual funds enjoy a tax arbitrage. That is after one year from the date of investment, your capital gains are entirely tax-free, irrespective of your returns and whether you have invested one time via lumpsum mode or every month via the systematic investment plan (SIP) route. As per current laws, your maturity amount will neither be taxable nor will you have to pay any other charge on maturity.

HOW TO INVEST: Thumb rules are meant for beginners. What percentage of your investment goes into equity funds should be a function of your risk taking capacity, investment horizon, current investments and your financial goals. If you are investing for your child's education and marriage, with these goals more than a decade later, and since all your investments would predominantly be via the SIP mode, you can invest entirely in diversified equity mutual funds as of now. A few years later, based on the prevailing circumstances your asset allocation can be shifted more towards debt mutaul funds and/or traditional avenues.

CAVEAT: Invest in a carefully created portfolio of diversified equity funds (5-7 schemes at best) chosen with professional help and with a medium to long term horizon. It pays to pay for professional advice and it may cost dearly if one ventures out on his own.

Nirav Panchmatia is founder & CEO, AUM Financial Advisors

PAL'S FINANCIAL GOALS FOR DAUGHTER

Goal	Approximate amount needed today (Rs)	Age: Current/ on Goal (Years)	Time left to achieve Goal (years)	Estimated Future Amount (Rs)	Monthly Investment (Rs)	One time Investment today (Rs)
Higher Education	10 lakh	5/18	13	24.1 lakh	5,750	4.65 lakh
Marriage	15 lakh	5/24	19	54.25 lakh	5,150	4.90 lakh
Total	25 lakh	-	-	78.35 lakh	10,900	9.55 lakh

INVESTOR QUERY

OF LATE WE RECEIVED QUERIES FROM SOME READERS ABOUT RAJIV GANDHI EQUITY SAVINGS SCHEME (RGESS), ITS WORKINGS, TAX IMPLICATIONS ETC. HERE ARE SOME BASICS ABOUT RGESS:

STRUCTURE:
There are mutual fund schemes that adhere to RGESS rules notified by the government. These funds invest in only those stocks which are notified under RGESS.

RGESS FOR TAX BENEFITS:
RGESS provides tax benefits to investors who are investing the equity market for the first time. These benefits accrue under Section 80CCG of the Income Tax Act. This is in addition to Section 80C of the Income tax act.

INVESTOR PROFILE:
Tax deductions are available to only those new retail investors whose gross total income for the financial year in which the investment is made is less than or equal to Rs 12 lakh.

HOW MUCH IS TAX DEDUCTIBLE:
New retail investors can invest up to Rs 50,000 in a financial year and under Section 80CCG of the Income Tax Act, 50% of that is tax deductible. This benefit is in addition to the tax benefits available under Section 80C of the Income Tax Act.

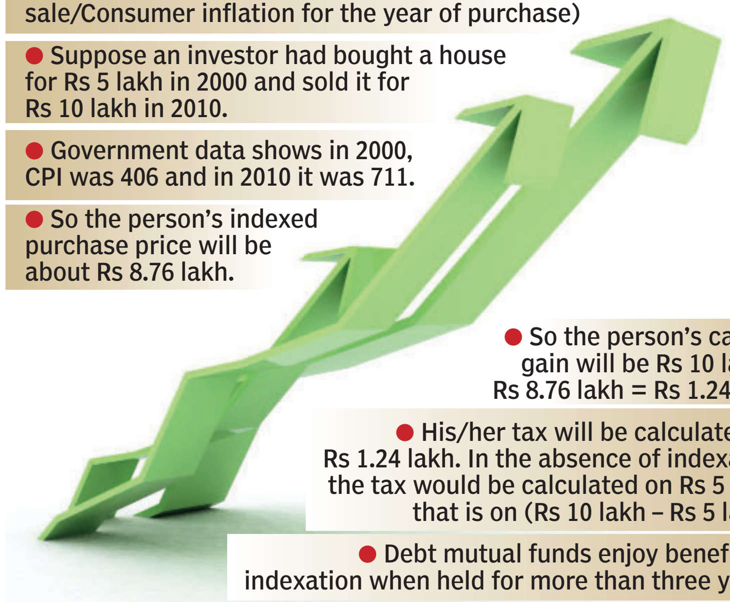
LOCK-IN:
There is a three-year lock-in for RGESS investors. However, after the first year the investor is allowed to shift his/her RGESS investments among other investments which are also RGESS approved.

WHO CAN INVEST UNDER RGESS:
A new retail investor can invest in RGESS. Such an investor is defined as any Indian resident individual who does not have a demat account, one with a demat account but has not transacted in equity or derivatives segment, or one who has a demat account as a joint holder.

Since its launch three years ago, the response to RGESS has been muted. Lately there have been news reports that the government is contemplating to bring in some changes which will make it attractive to get more investors into the equity market.

How indexation works

Indexation is a process by which the government compensates investors in debt, gold, real estate etc so that the investor does not have to incur any loss in real terms. Due to inflation, the market price of an asset may not reflect the real value of the asset. So if the government taxes an investor going by the market price, that may turn out to be a disincentive to invest. Hence government allows inflation-adjusted selling price to determine the capital gain for incidence of taxation on the seller.



- Capital gain = (Selling price at market value – Inflation-adjusted purchase price)
- Inflation-adjusted purchase price = Original purchase price * (Consumer inflation index for the year of sale/Consumer inflation for the year of purchase)
- Suppose an investor had bought a house for Rs 5 lakh in 2000 and sold it for Rs 10 lakh in 2010.
- Government data shows in 2000, CPI was 406 and in 2010 it was 711.
- So the person's indexed purchase price will be about Rs 8.76 lakh.
- So the person's capital gain will be Rs 10 lakh – Rs 8.76 lakh = Rs 1.24 lakh
- His/her tax will be calculated on Rs 1.24 lakh. In the absence of indexation the tax would be calculated on Rs 5 lakh, that is on (Rs 10 lakh – Rs 5 lakh).
- Debt mutual funds enjoy benefits of indexation when held for more than three years.

DEMYSTIFIER

Why the troubles in the Chinese market matter for India?

Swatantra Kumar answers: In the last few months, weakness in the Chinese economy and a sliding stock market there have been affecting the global markets, including India. This is because China is the second largest economy in the world and also was the growth engine of the world for about two decades. A slowdown in China means that would naturally have its impact around the globe. A slowing China means less demand for mineral ores like Iron, copper, bauxite, zinc etc. Since some of the Indian companies export mineral ores to China, declining demand is hurting their business. Also due to the low demand for Chinese goods in the international market, the prices of goods produced in that country is also coming down. Once these goods are entering India, local producers of those goods are also being hurt since they are being forced to lower the prices of their products. This is one of the several ways how a slowing China is hurting India.

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