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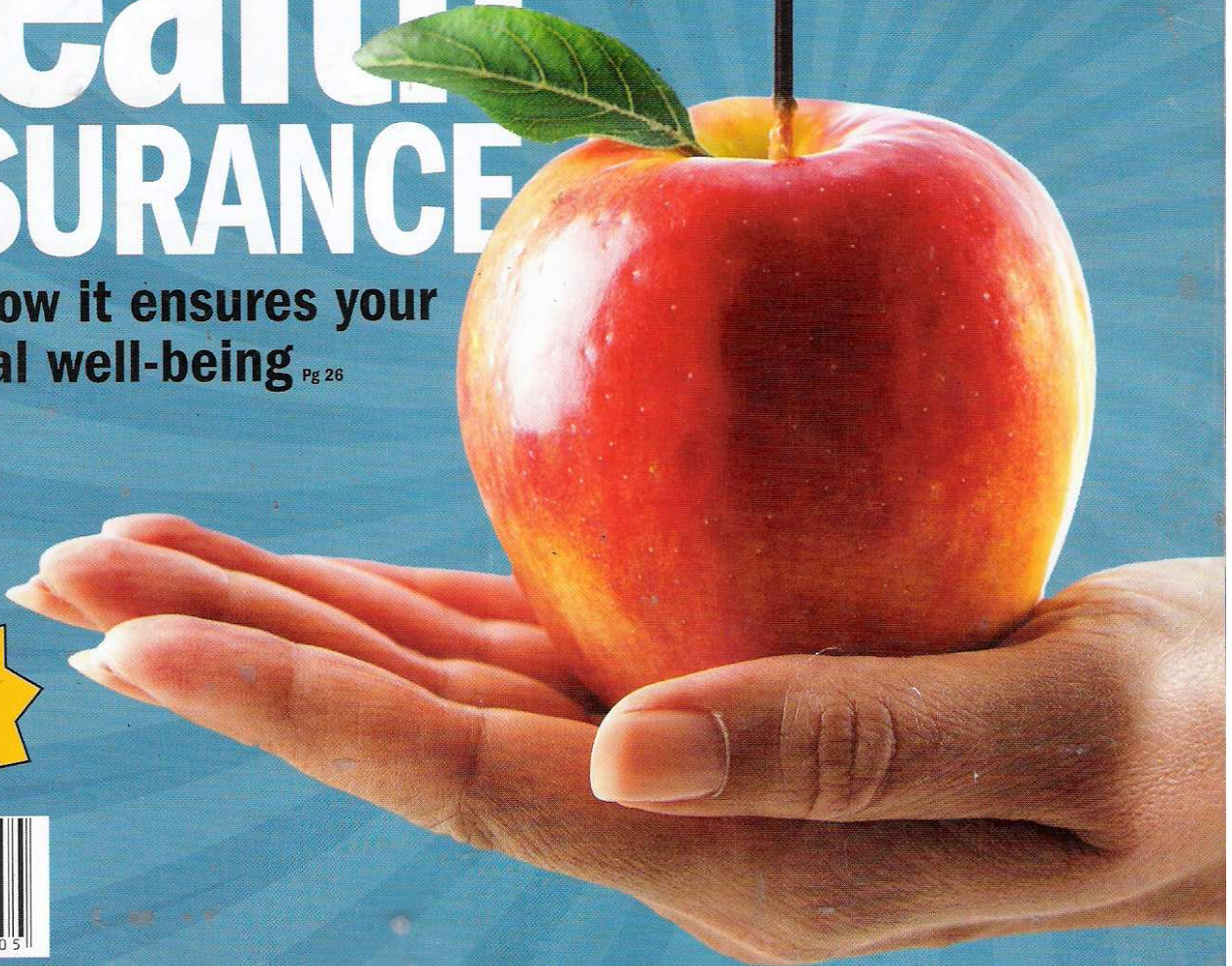
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# Banking on Mutual Funds

The conservative Indian investor has always believed in bank deposits. Now mutual fund houses are trying to woo them through customised schemes | **By Dipak Mondal**

**M**utual funds are trying hard to wean away the conservative Indian investor from bank deposits.

Mutual funds, over the last decade have emerged as a popular investment option, as they offer a wide array of products aimed at investors with different risk appetites and investment objectives. But still, over 40% of Indian household savings, according to a Karvy Private Wealth report, find

their way into bank deposits. And now, the mutual fund industry, which has, till now, been able to tap just about 3.8% of household savings in India, is planning to bite into that pie with greater product diversification and innovation. Several funds have launched a slew of products with risk profiles and tenures, similar to different kinds of bank offerings. *Money Today* does an in depth analysis of mutual fund schemes that offer some interesting alternatives to the bank-obsessed

investor. Here is a look at the fare on offer.

## LIQUID FUNDS VS SAVINGS ACCOUNTS

The primary objective of having a savings account with a bank is to ensure that your surplus cash remains safe and completely liquid. Along with this peace of mind you also earn an yearly interest of 3.5 per cent on your funds. Liquid schemes of funds come very close to such accounts.

**3.8%**

of the country's total household savings gets invested in different mutual funds schemes

**40%**

household savings in India goes into bank fixed deposits, bonds and savings account



Illustration: PRAGATI

Such schemes are often used by high net worth individuals (HNIs) as savings account. Money in a liquid fund can be redeemed within a day of submission of a withdrawal application.

These funds invest in money market instruments – certificates of deposit (CDs), commercial paper (CP), treasury bills, government securities and other debt paper with maturities of up to 91 days.

Besides being liquid in nature, these funds offer higher and more tax-efficient returns than your savings accounts. While you earn an annual interest of 3.5% on your deposits in savings account, by investing in liquid funds you make on an average 5.5% a year. You can invest in these funds for as short a period as one day. No exit load is charged for any withdrawal.

Abhinav Angirish, founder and managing director, Abchlor Investment Advisors says, "One can invest in liquid funds for very short periods – a day or a fortnight. No banks would allow you to open a savings account for such a small period. The rate of interest is also higher than that offered by a savings account."

**How Liquid Funds Beat Savings Accounts:** The net asset values (NAVs) of liquid funds are declared even on Saturdays and Sundays. Besides, the investment is done on the previous day's NAV. These two features attract a large number of investors to such funds.

Consider a situation, where you have received a large sum on a Friday to be used for a certain purpose on Monday. So, instead of keeping the money in your bank account, you can invest it in a liquid fund at Thursday's NAV and earn a decent return on your investment.

Another strategy used by investors to benefit from liquid

mutual funds is to invest a certain amount in a liquid fund and systematically transfer it to an equity fund. This strategy helps you gain from the liquid fund as well as from the equity fund.

A similar approach is used by Bharti AXA Liquidity scheme to woo investors. The daily gains from Bharti AXA Liquid Fund and Treasury Advantage Fund are transferred to Bharti AXA Equity Fund or Bharti AXA Focused Infrastructure Fund.

Prateek Agarwal, head, equity at Bharti AXA Investment Manager, says the strategy used in the fund's liquid scheme can be used by investors to earn a higher return at a very low risk. "The average annual return given by liquid funds is between 5 and 5.5% against the 3.5% given by savings accounts. If you transfer only the daily gains from liquid funds in equity funds, it will give not only capital protection benefits but also high equity returns," Agarwal adds.

But so far, these funds are mostly used by institutions and HNIs for parking their short-term surplus money. However, financial planners say retail investors should also look at these funds to make smart gains. Usually, the minimum investment for retail investors in such funds ranges from Rs 5,000 to Rs 10,000.

**Tax implications and expenses:** There is no getting away from tax on dividend income which is 25% for liquid funds and 12.5% for other debt funds. Also, capital gains tax is applicable on liquid funds, as it is for all debt funds. In a typical debt fund, the long-term capital gains tax without indexation is 10%, while it is 20% with indexation. Short-term capital gains tax is deducted based on your income tax slab. Indexation here means adjusting your tax liabilities to inflation.



**“You can invest in liquid funds even for a day or two. You can't open a savings bank account for such a short period”**

**Abhinav Angirish** Founder and Managing Director, Abchlor Investment Advisors

The fee charged by liquid funds is usually lower than most other funds. It ranges from 1% to 1.5% of the corpus invested.

### **FIXED MATURITY PLANS VS FIXED DEPOSITS**

According to RBI, close to Rs 48 lakh crore is invested in bank fixed deposits (FDs), in the country. And the typical FD investor in India, who is the mutual fund industry's next target, is hard to please—he is conservative and is not only looking for capital protection but also guaranteed returns. But, the nature of the mutual fund beast is such that it cannot completely guarantee returns. However, some funds have come out with schemes that have very low risk portfolios and often generate better returns than FDs, even though they do not guarantee capital appreciation.

These are fixed maturity plans (FMPs), closed-ended debt funds which hold debt paper with maturity periods lower than or equal to their own. This along with closed-ended nature minimises the interest rate risk (risk due to potential changes in interest rates).

**How FMPs score over FDs:** The closed-ended nature of an FMP

**While you earn an annual interest of 3.5% on your deposits in savings account, you make 4-7% in liquid funds.**

ensures that the fund holds the debt papers till maturity and hence the returns are almost guaranteed. The average annual return from FMPs over the past three years however has not been too high, ranging from 6.5% to 7%, but more than half of the available FMPs, with maturity periods of more than three years have delivered over 7% returns.

There is a lot to choose from with FMP maturity periods ranging from three months to five years.

Tax-efficiency is another positive feature of FMPs. Fund houses often launch FMPs which have maturities of just over a year - 370 or 390 days. FMPs with such maturity periods help investors benefit from double indexation (*See Benefit of Double Indexation*), where capital gains are adjusted for inflation twice, once in the year of investment and then at the time of maturity.

**The FMP Disadvantage:** The closed-ended nature of FMPs can prove to be a spoiler for investors, as they cannot redeem their investments prematurely. The only way to get out of an FMP is to sell the units on a stock exchange. However, transaction volumes for FMPs are abysmally low, making the funds virtually illiquid.

In case of FDs—barring the ones used for tax saving under sec-



**“FMPs have become popular as they offer similar risk and return profile like conventional debt instruments”**

**Kalpen Parekh**, Deputy Chief Executive Officer, IDFC Mutual Fund

tion 80 C—investors can make premature withdrawals by sacrificing a bit of interest income, which is just 1% less in case of premature withdrawals.

Alok Singh, head, fixed income, BNP Paribas Mutual Fund says FMPs were closer to FDs in their former avatar when early exits were allowed. “With the ban on withdrawal before maturity, FMPs certainly are less attractive for many investors,” he adds.

**CAPITAL PROTECTION FUNDS VS BANK FDs**

Capital Protection Funds are closed-ended schemes with tenures ranging from one to five years. These funds invest a large portion (up to 90%) of their portfolio in good

quality debt paper, which have maturities similar to the tenures of the schemes, and the rest in equity instruments. While the money invested in debt instruments tries to recover the principal amount, the return from the portion in equity adds to it, giving investors both capital protection and good returns.

So, while exposure in debt papers held till maturity ensures that the capital is protected, the performance of the equity portion determines the kind of return one can expect from such funds. Again, investment in these funds cannot be redeemed prematurely and hence liquidity is a concern.

Kalpen Parekh, deputy chief executive officer, IDFC Mutual Fund, says, “Capital protection funds have recently been offered to investors and investor interest is increasing. However, FMPs have been more popular as they invest only in debt instruments and offer similar risk and return profile like conventional debt instruments. In the last 6 months, FMPs have added more than 50,000 crore of assets between retail and corporate investors.”

**MIPs VS BANK MONTHLY INCOME SCHEMES**

Mutual funds have been pitching monthly income plans (MIPs) as a source of regular income for

**Benefit of double indexation**

	FMP	FD
Investment (Rs)	1000	1000
Return (%)	9.0	9.0
Tenure (Days)	375	375
Inflation (%)	5.0	NA
Indexed cost	1102.5	NA
Maturity value	1094.16	1094.16
Interest income	94.16	94.16
Capital gain/(loss)	-8.34	NA
Tax rate*	30	30
Tax outgo (Rs)	Nil	28.25

*Considering the highest income-tax slab*

**Taxation of mutual funds vs fixed deposits**

	EQUITY FUND	DEBT FUND	FIXED DEPOSITS
Tax on dividend	Nil	25% on Liquid funds 12.5% on other debt funds	NA
Long term capital gains tax	Nil	10% without indexation 20% with indexation	As per income tax slab
Short-term Capital gains tax	15%	As per income tax slab	As per income tax slab
TDS	Not applicable for Indian residents	Not applicable for Indian residents	Applicable if the interest income is more than Rs 10,000

*Source: Scheme information documents*

## Top 10 FMPs rated on 3-year returns

SCHEME NAME	RETURN (%)		
	3 MONTHS	1 YEAR	3 YEAR
Tata FIPF B3-Reg(G)	2.05	7.07	8.99
Tata FIPF C3-Reg(G)	1.29	5.61	6.52
Tata FIPF B2 -Reg(G)	1.84	5.45	6.25
Tata FIPF A2-Reg(G)	1.95	5.67	5.91
FT FTF VIII-60M-A(G)	-3.37	6.23	5.17
FT FTF IV-60M(G)	-2.93	6.34	4.65
Tata FIPF A3-Reg(G)	1.90	5.80	4.64
FT FTF VI-60M(G)	-3.16	6.30	4.51
Tata FIPF C2-Reg(G)	0.73	0.69	4.44
Tata FIPF A1-Reg(G)	0.13	0.04	3.50

Source: Accord Fintech

## Top 10 MIPs rated on 5-year returns

SCHEME NAME	RETURN (%)		
	1 YEAR	3 YEAR	5 YEAR
Reliance MIP(G)	6.49	12.82	11.52
Canara Robeco MIP(G)	7.82	8.39	11.51
HDFC MIP-LTP(G)	8.76	10.07	11.11
ICICI Pru Child Care & Study Plan	10.66	8.11	10.62
Birla SL MIP II-Savings 5(G)	5.42	10.98	9.69
HSBC MIP-Savings(G)	4.37	6.69	9.66
Birla SL Monthly Income(G)	6.30	7.60	9.64
L&T MIP(G)	4.53	5.50	9.36
UTI MIS Adv(G)	4.91	6.73	9.30
LICMF Floater MIP-A(G)	6.00	6.38	9.28

Source: Accord Fintech

investors against the monthly income schemes (MIS) of banks. MIPs are debt-oriented hybrid funds with over 65% of portfolio invested in debt instruments and the rest in equities.

These schemes pay regular dividends (monthly, quarterly and semi-annually). Bank schemes on the other hand are fixed deposit schemes with interest paid in equal monthly installments.

Mutual fund MIPs try to offer returns which are better than bank FDs with the help of their exposure to equities. While interest on bank FDs ranges from 6% to 9%, MIPs have given an average return of between 6% and 7% over the past five years with the better performing funds giving between 10% and 12%. "Equity exposure of MIPs makes them more attractive in terms of returns than monthly income schemes of banks, however, market risk also increases with the equity component," says Anil Rego, chief executive officer, Rights Horizon, a Mangalore-based financial planning company.

However, investors must remember that regular dividend payouts in MIPs are subject to availability of funds. If the scheme is making losses, it is possible that the fund house may not pay dividend. In 2008, many MIPs skipped monthly dividend payments due to adverse market conditions.

Dividends on MIPs are taxable at 12.5%. One way to escape the div-

idend distribution tax is to go for a growth plan and choose systematic withdrawal option. Under systematic withdrawal, you can either withdraw the capital appreciated portion or a predetermined amount. Any withdrawal within a year of investment, though, invites a 1% exit load.

### RECURRING DEPOSITS VS SIPs IN MUTUAL FUNDS

How often do you go for goal-based savings such as putting a sum aside for your children's education or marriage, for buying a car or for a holiday abroad? Banks offer you recurring deposit schemes, so that you can save a small sum every month to create a fund for your future goals.

Recurring deposits offer interest rates equal to those offered by FDs and the maturity period can

vary from one year to five years.

But if you find the interest rates not very attractive, you can try out a systematic investment plan (SIP) of a good equity fund or a balanced fund. The returns are generally higher than those of recurring deposits but there is always the market risk involved.

"It is possible that at the time when you need the money, equity markets may have fallen sharply and your investment may have shrunk," says Dewang Shah, an independent financial planner.

These schemes work well if your time horizon is between three to five years. Often people do not realise that if they invest for a year in an SIP, each monthly installment should complete a year or the investor should keep the money invested at least for 2 years. Otherwise, they would not only have to pay short-term capital gains tax but also exit load, which most fund houses charge on withdrawals before completion of a year.

The above mentioned schemes are well-thought out and smartly carved to tap a larger chunk of Indian household savings. But analysts do not see them as a perfect replacement for traditional banking products, which has greater acceptability. Most mutual fund products have risks involved, which make many risk-averse investors quite wary. How the still-nascent mutual fund sector addresses the issue, remains to be seen.



**“Equity exposure of MIPs makes them more attractive than bank monthly income schemes in terms of returns”**

**Anil Rego** Chief executive officer, Rights Horizon