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Investing in FDs and Tax Free Bonds

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Financial Guidance by ***T. Shrikanth Bhagavat, MD, Hexagon Capital Advisors***

Q) *I have Rs 15 lakh invested in debt mutual funds. I want to invest Rs 5 lakh in addition to this. Should I invest this in fixed deposits or tax-free bonds? I pay tax at 30 per cent.*

Lakshika Bennur

Both fixed deposits (FDs) and tax-free bonds are relatively safe fixed income investments. However, in the current scenario, tax-free bonds have several advantages over FDs.

Unlike tax-free bonds, investments in FDs are taxable. Currently, 10-year fixed deposit rates are between 8.50 per cent and nine per cent. As your tax slab is 30 per cent, your post-tax returns will only be around six per cent. Investments in fixed deposits are also liable to TDS (Tax Deducted at Source), which will lower your returns. On the other hand, TDS does not apply to investments in tax-free bonds.

In the current fiscal year (which ends in March 2013), the government has allowed state-run companies to raise Rs 60000 crore by issuing tax-free bonds. In line with this, IIFCL launched its public issue of tax-free bonds on December 26, 2012. HUDCO and IRFC have also announced issuing tax-free bonds in January 2013. These companies have high credit ratings, as indicated in the table. The 10-year interest rates offered by these companies are also significantly higher than the post-tax rates of comparable bank FDs.

When choosing the best tax-free bonds to invest in, you should compare the interest rates of the new tax-free bonds with the yield-to-maturity (YTM) of tax-free bonds currently trading in the secondary market. You should invest in the new bond issue if the coupon rate/YTM it offers is higher than the YTM of the existing bonds in the secondary market. You should also look at the issue size of the bonds, as higher issue sizes generally indicate that the bonds will have more liquidity when they are listed.

Additionally, you may benefit from capital appreciation by investing in tax-free bonds. In times of falling interest rates, the price of your bonds may increase and you could sell the bonds in the secondary market for a profit. FDs do not offer any such upside potential. It is quite likely that the RBI may choose to lower the policy rates in the future if inflation decreases. In the second quarterly review of the monetary policy on October 30, 2012, the RBI governor Dr Subbarao stated that there is “a reasonable likelihood of further policy easing in the fourth quarter of this fiscal year”.

Company Name	Issue Size (Rs/Crore)	Open Date	Close Date	Tenure (Years)	Yields % (Category IV Investors)	Rating
IIFCL	1500	41269	41285	10 \ 15 \ 20	7.69/7.86/7.90	AAA (ICRA)
HUDCO	750	41283	41296	10 \ 15	7.84/8.01	AA+ (CARE)
IRFC	1000	41295	41303	10 \ 15	7.68/7.84	AAA by CRISIL, CARE & ICRA

Tax-free bonds allow you to invest your money for as long as 20 years. In contrast, most FDs have a maximum tenure of only 10 years. At the end of this period, you will have to invest in a new FD. If you wish to redeem your investments in tax-free bonds before maturity, you can sell them in the secondary market without incurring any penalties. In contrast, you may have to pay a penalty as high as one per cent if you choose to withdraw your FD investment early.

If you choose to invest in tax-free bonds, you should invest in a public issue rather than waiting for the bonds to be listed in the secondary market. This is because for new bond issues, companies offer a higher interest rate of 50 basis points to Category IV investors (retail investors). However, this additional interest rate is only available to the original investors who are allotted bonds at issue. Once the original investors sell or transfer these bonds in the secondary market, the buyers will receive lower interest rates.

Remember that the secondary market may be illiquid, especially for small-ticket transactions. Furthermore, capital gains made on the sale of tax-free bonds in the secondary market are taxable. In addition, you may need a demat account to buy these bonds.

Answered by -

T Srikanth Bhagavat
Managing Director,
Hexagon Capital Advisors
www.hexagononline.com