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Debt Funds versus Equity Funds

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*Individuals with shorter investment horizons should invest in debt funds rather than in equity funds, says **T Srikanth Bhagavat***

In January 2012, I invested Rs 130000 in Franklin India Smaller Companies. By the end of this year, I wish to have Rs 2 lakh for a holiday. Should I continue investing in Franklin Smaller Companies or redeem and invest in another fund?

- Rajneesh Kumar

Your investment in Franklin India Smaller Companies would have grown at about 50 per cent (on an absolute basis) and would now be worth around Rs 194406 (assuming the start date of your investment to be January 2, 2012; NAV as of February 11, 2013). However, there is no guarantee that your investment will continue to grow at the same rate this year. Investments in equity funds are subject to volatility in the short-run. Small- and Mid-Cap funds such as Franklin India Smaller Companies are especially risky. As your investment horizon is short, you should invest in debt funds rather than in equity funds.

You could consider short-term debt funds rather than long-term ones. The former may not generate spectacular returns when the rates fall, but have lower downside risks than their longer-duration counterparts. Additionally, long-term debt funds generally have higher exit loads – sometimes more than a year. These funds may underperform short-term funds if the yields rise.

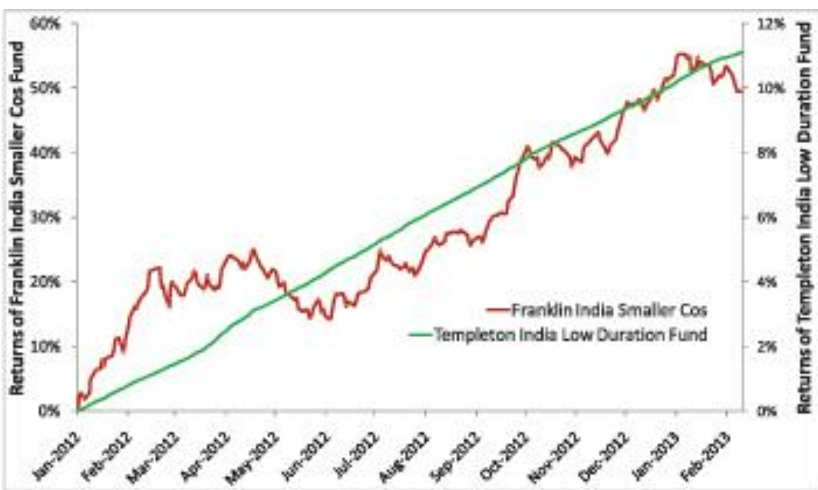
In its last policy review on January 29, 2013, the RBI had lowered the repo rate, but the timing of future rate cuts is uncertain. The headline (WPI) inflation eased to 6.62 per cent in January 2013, but retail inflation (measured by the CPI) rose to 10.79 per cent – marking the fourth consecutive monthly increase. The RBI is also concerned about India's large current account deficit (CAD), which rose to a record high of 5.4 per cent of GDP in the second quarter of FY13 (Source: Reserve Bank of India).

The short-term funds shown in the table are among the top performers in their category:

Scheme Performance As On February 13, 2013							
	Annualised Returns				CAGR		
Scheme Name	1	3	6	9	1	2	3
	Months				Years		
Birla SL Dynamic Bond Fund(G)	5.4	9.68	9.99	10.35	10.15	10.27	8.57
HDFC High Interest Fund-STP(G)	5.07	8.47	9.39	10.05	9.55	9.44	7.84
ICICI Pru Short Term Plan(G)	6	9.11	9.59	9.96	9.59	9.52	7.77
IDFC SSIF - MT(G)	5.25	9.45	9.67	10.18	9.82	9.97	8.58
Templeton India Low Duration Fund(G)	7.05	8.33	8.92	9.49	9.97	10.04	-
Templeton India Short Term Income Plan(G)	6.05	9.12	9.81	10.23	10.07	9.81	8.31

Templeton India Low Duration Fund's Growth option was launched in July 2010.

You could invest in Templeton India Low Duration Fund (TILDF), as you can simply switch from Franklin India Smaller Companies. This would be simpler and faster than shifting your investments to a different fund house. Templeton India Short-Term Income Plan has generated higher returns but has a one-year exit load, which may drag your returns down if you redeem your investment in December.



Franklin India Smaller Companies is a relatively more volatile fund. In contrast, TILDF is a more consistent fund with stable returns. TILDF generally has a low modified duration to minimise interest rate sensitivity, while offering relatively higher accruals. In December, the fund had invested 58 per cent of its corpus in money market instruments and the remainder was invested in corporate debt. As of December 31, 2012, the fund had a modified duration of 0.35 years and a yield to maturity of 9.57 per cent (pre-expenses). The fund has a three-month exit load.

As you fall in the highest tax bracket, you could choose the Quarterly Dividend option of TILDF as this would be more tax effective than the Growth option. As your investment horizon is less than a year, you will incur Dividend Distribution Tax (DDT) of 13.519 per cent on your investment in the Quarterly Dividend option. In the Growth option, in contrast, you will have to pay Capital Gains Tax (CGT) of 30 per cent (plus cess) – this will be based on your tax slab. By investing in TILDF, you will be able to achieve your goal by December 2013 even after the expenses and taxes are deducted.

In conclusion, opting for a short-term fund such as Templeton India Low Duration Fund will help you grow your investment with steady returns and low volatility. You may also benefit from capital appreciation if the interest rates fall.