

To Invest In Equity Or Debt Funds?

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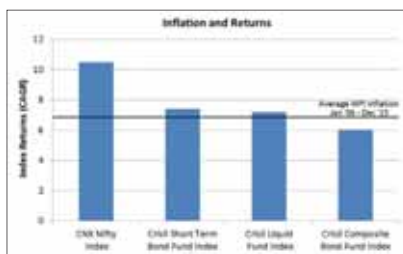
I am 53 years old. I retired 3 years ago and the majority of my monthly income comes from rent as most of my investments are in real estate. After expenses and my monthly investment in fixed deposits, I have about ₹35,000 left each month. Should I invest this in equity or debt funds? I pay tax at 30 per cent.

- Sam Abdul Master

Go for the best of both worlds by investing in both equity and debt funds! You could follow the “core and satellite” approach. Debt funds should form the bulk of your portfolio (the “core”), while a small portion can be invested in equity funds for higher returns (the “satellite”). A modest allocation to equity funds will enable you to beat inflation in the long-run.

Between January 2006 and December 2013, annual inflation (measured by the Wholesale Price Index) has averaged 6.86 per cent. As shown in the chart, the Nifty has beaten inflation and has generated a CAGR of more than 10 per cent. The CRISIL Liquid Fund Index and the CRISIL Short Term Fund Index have generated marginally higher returns than inflation

while the CRISIL Composite Bond Fund Index (which is the benchmark for long-duration funds) has not managed to beat inflation.



However, the CRISIL Composite Bond Fund Index has generated higher returns during periods of falling interest rates. Currently, interest rates are close to the peak. On January 28th, the RBI Governor hinted that further rate hikes are not imminent and even suggested that the central bank may be able to focus on growth and reduce interest rates if inflation declines faster than expected.

Consequently, the investments in long-duration funds may help you benefit from capital appreciation over the next few years if interest rates fall. The table below highlights this phenomenon.

Absolute Returns as on 7 February 2014

Index	Falling Yields Nov '11 - May '13	Rising Yields May '13 - Feb '14
Crisil Liquid Fund Index	13.23	6.55
Crisil Short Term Bond Fund Index	14.87	5.00
Crisil Composite Bond Fund Index	19.27	-2.03

For example, in November 2011, the benchmark 10-year government bond yield was close to 9 per cent but fell to nearly 7 per cent in May 2013. During this period, the CRISIL Composite Bond Fund Index outperformed the CRISIL Short Term Bond Fund Index and the CRISIL Liquid Fund Index as shown in the table.

However, this trend was reversed last year and the benchmark 10-year yield closed at 8.74 per cent on 7th February 2014. As shown in the table, money market funds and short-term funds are generally less