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Remain Invested In Debt Funds

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I have built a substantial debt fund portfolio in short term, dynamic and bond opportunities funds. I have SIPs going into bond funds, too. Now with the new tax laws for debt funds, I am disappointed. Should I just pull out and invest all of it in bank fixed deposits? Some of the savings are for my children's education which will be required in 5 to 7 years time and some for a property down payment due before the end of this year.

- Sharath D., Pune

The new tax laws for debt funds have been unkind to debt funds but it is not that all is lost. The changes impact the short term investor more than the long term ones – and the change is in the way long term capital gains tax will be calculated.

- Earlier, long term was defined as a holding period of 365 days, which has now changed to 36 months in the case of debt funds.
- The rate of tax applicable was either a flat 10 per cent or 20 per cent with indexation which has now changed to only 20 per cent with indexation benefits.

In any case, the dividend option (for debt funds) had already become expensive for those in the lower tax brackets and the gap had closed considerably for those in the higher tax brackets. Now it has all but outlived its utility. Long term investors will get taxed at 20 per cent with indexation and this will still compare favourably with bank fixed deposits as there is no indexation benefit on interest from deposits. This in itself will enable investors from all categories to take home a better post-tax return from debt funds or FMPs than bank deposits.

	FMP	Fixed Deposit
Investment	Rs.100.00	Rs.100.00
Return, pa (assumed)	9.00%	9.00%
Tax	20.00%	30.00%
Value after 36 months, post-tax		Rs.120.11
Value after 36 months, with indexation*	Rs.127.20	NA

*Assuming a 6% rate of inflation

The above has been computed using 9 per cent as an illustration. At the same gross rate of return, an FMP has the potential to return higher post tax gains. An open-ended debt fund will carry some risks like interest rate risk. At a steady state, the above table would be applicable; if

interest rates in the system happen to go up, in a medium or long term debt fund you would see some capital losses bringing down the rate of return; but if interest rates were to go down over the next 2–3 years, as is anticipated, there would be capital gains beyond what has been illustrated, taking your overall return higher. The RBI has indicated that its inflation target over next two years is 6 per cent, which if achieved will surely bring down interest rates. Trends in current account, fiscal deficit, inflation control and a need for lower rates to stimulate

economic growth point to a high probability of lower rates in the future. Even a 0.75 per cent reduction has the potential to increase gains by 2-3 per cent, making open-ended debt funds an attractive investment.

So we have taxation, better returns and manageable liquidity as three important points in favour of open-ended debt funds. An option which may be worth considering is the option to roll over your maturing FMPs for an additional period making total holding period to 36 months and taking advantage of the long term capital gains tax rate. This is an option that would work for those investors not wanting to take the risk of interest rates moving unfavourably and liquidity not required till the end of the 36th month!

In this light, I would recommend continuation of your investments in open-ended debt funds for the goal of children's education. But the short term need for property down payment can be evaluated on the basis of gross return in FD versus debt fund while keeping in mind the liquidity offered in open-ended debt funds like liquid plans or short term funds.

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Disclaimer: Past performance does not guarantee future returns. The mutual funds which have been mentioned are indicative of historical performance only. Please consult your financial advisor before investing in mutual funds.

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