Achieve financial goals with fixed income funds

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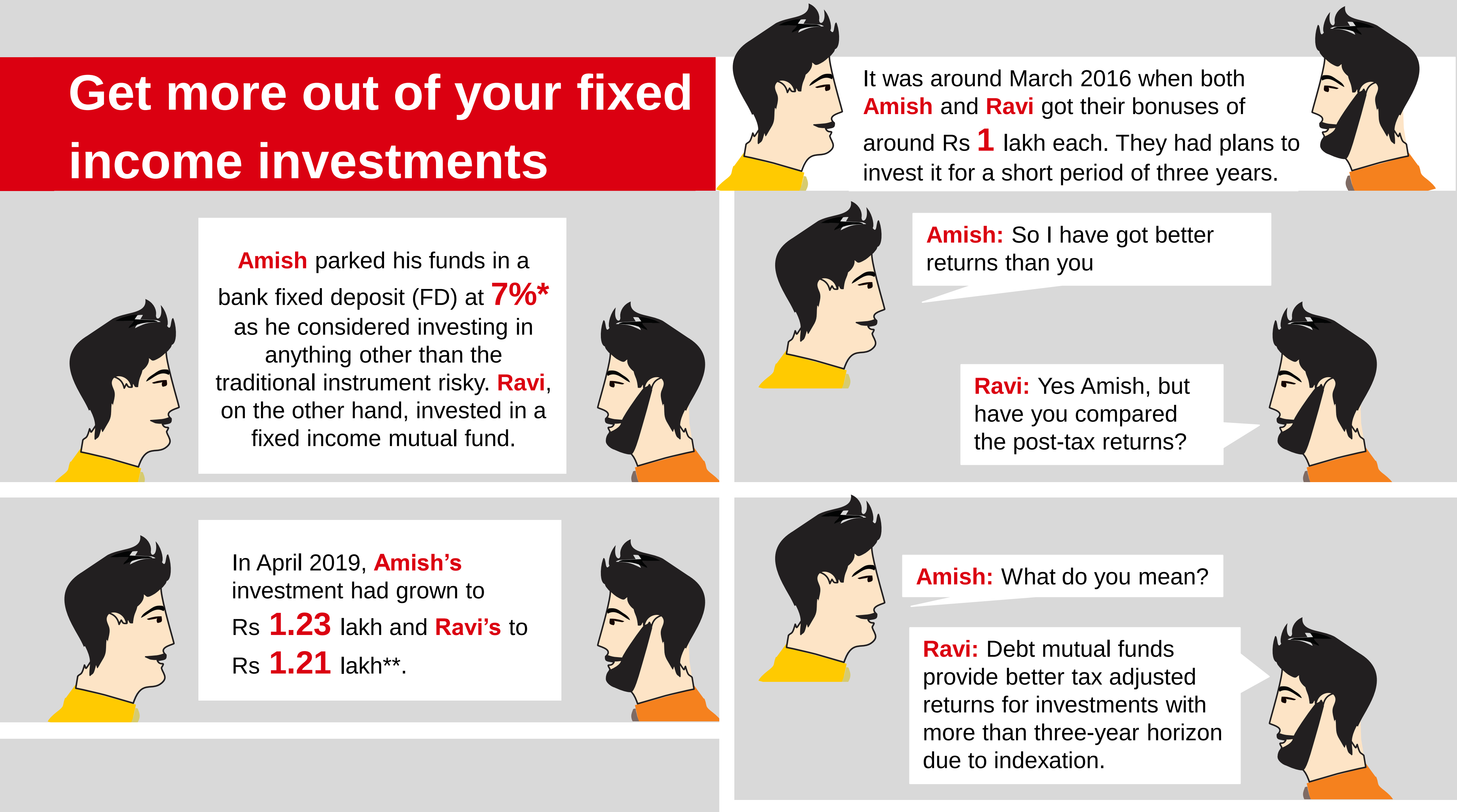
HSBC
Global Asset
Management

An Investor awareness program initiative

Get more out of your fixed income investments



Investment period considered is for three years.

* Based on RBI FD data.

** Based on point to point three-year CAGR return of CRISIL Gilt Fund Performance Index as on December 31, 2019.

The above data analysis/ chart is for illustration purpose only.

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Get more out of debt investments

Ravi: So as you can see from the table, while you generated better returns, I was able to reduce the tax liability through indexation and thus increase my overall returns.

	Fixed income fund	**Bank FD[#]**
Amount invested	Rs 1 lakh	Rs 1 lakh
Holding period	3 years	3 years
Returns assumed	6.69%***	7.00%***
Investment value	Rs 1.21 lakh	Rs 1.23 lakh
Inflation rate of indexation	2.29%[@]	NA
Indexed cost of investment	Rs 1.09 lakh*	NA
Taxable income	Rs 11,956	Rs 22,504
Tax payable^^^	Rs 2,391^	Rs 6,751^^
Post tax gains	Rs 19,405	Rs 15.753[#]
Post tax returns	5.98%	5.00%

@ *Cost Inflation Index (CII) is taken for the year of investment and that of the year of redemption, i.e. fiscals 2017 and 2020 respectively, and the rates used are actual rates prescribed by income tax authorities for these years.

* Computed on the basis of CII (fiscals 2017-2020) *** Fixed income fund return - Represented by CRISIL Gilt Fund Performance Index and Bank FD return represented by RBI FD data

^ taxed at 20% after taking into account indexation benefit.

^^ Tax on interest is payable at income tax slab rate; here it is assumed at the highest tax bracket of 30%.

As per prevailing tax laws. It is recommended to consult financial advisor before taking any investment decisions.

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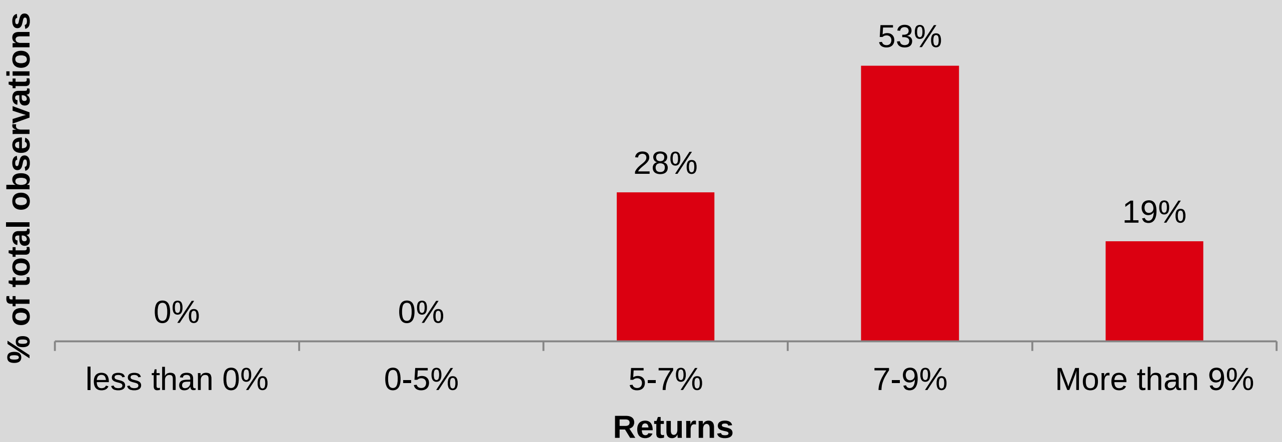
Get more out of your fixed income investments

Amish: Hmm… But what about returns? Since they are market-linked in your case, they are not predictable.

Ravi: Yes Amish, you are right. The returns in my case are marked-linked. But these funds are professionally managed with investments diversified across fixed income instruments, which reduces the overall risk.

This can be seen in returns distribution of fixed income funds (represented by performance of short duration category) which shows that historically they have managed to give positive returns for a three-year time frame.

Returns distribution of short term debt funds***



*** Analysis based on three-year daily rolling returns of CRISIL-ranked short duration schemes from April 1, 2002, to December 31, 2019.

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Common errors make while investing in fixed income assets

Like Amish, many investors often err on certain counts while investing in fixed income products:

Ignoring inflation

Ignoring inflation while investing in fixed income products can result in shortfall of funds required to meet financial goals. As fixed income funds are market-linked, they can earn investors higher inflation-adjusted returns than bank FDs.

Ignoring tax implication

Interest earned on FDs is taxable as per the investor's tax bracket. On the other hand, fixed income funds are more tax efficient* thanks to the indexation benefit. Most investors fail to see this while opting for 'safe' FDs.

I cannot withdraw my money easily from fixed income funds

Among fixed income funds, liquid funds provide high liquidity and are of low risk. They are an efficient alternative to park any surplus cash. You can instantly redeem money from a liquid fund and get a credit in the bank account on the next working day.**

There is no alternative to FDs

Fixed maturity plans (FMPs) offered by mutual funds may be a worthy alternative to FDs where funds generally remain invested till the maturity of the underlying security.

Ignoring capital appreciation provided by fixed income funds

Duration/ Gilt and credit risk funds, because of their active duration and credit management, offer potential capital appreciation, although with a marginally higher risk.

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Fixed income investment – a pillar of financial planning

Fixed income investments play a significant role in the financial planning process:

- Potential capital preservation is the primary focus of fixed income funds
- Some fixed income funds offer periodic income through dividends
- Some fixed income fund categories such as duration funds offer potential capital appreciation
- Fixed income funds reduce risk with diversified investments

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Fixed income investment – best for short-term goals

- In a rush to achieve a goal, especially a short-term one, many investors take a risk by investing in equities
- This may result in a shortfall risk if the investment go awry owing to short-term volatility
- Relevant fixed income products, in contrast, can ensure your goal is met without worry

Sameer's two lives:

Sameer needs Rs 7 lakh next year as part payment for the house he has booked. Assuming he has saved Rs 6.50 lakh today for this goal:

- Investing in equities can result in a shortfall of Rs 82,500, if the stock market falls 5% after a year
- Investing in fixed income fund such as liquid or ultra short duration fund has the potential to ensure Sameer meets his goal of amassing Rs 7 lakh, assuming 7% returns*

For representation purpose only.

* Based on 1-year return of CRISIL-ranked liquid fund category as on December 31, 2019

Note: The example is for illustration purpose only

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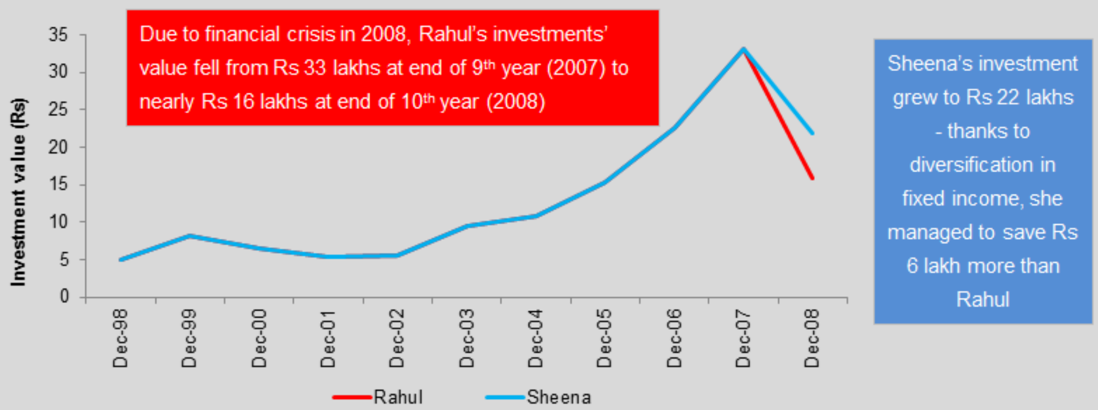
Fixed income investment – optimum asset allocation

- For medium- and long-term goals, smart asset allocation strategies with the help of fixed income and equity investments can work wonders
- Diversified fixed income investments will help you earn optimum risk-adjusted returns*
- A thumb rule of investing is that as the goal nears, more allocation should be made towards safer asset classes such as fixed income. This will help an investor avoid deviation arising from riskier asset classes such as equity.

Illustration

Rahul and Sheena invested Rs 5 lakh in 1998 for 10 years in equities. Rahul stayed invested in equities during the period. Sheena reduced equity allocation to 70% and parked 30% in fixed income in the ninth year in order to reduce her investments in relatively more volatile equity markets.



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Returns of equity asset class represented by S&P BSE Sensex.

Returns of debt asset class based on one-year return of CRISIL-ranked liquid fund category as of December 2008.

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Welcome to the world of fixed income funds

Recap: Why fixed income funds are smarter

- Traditional fixed income products such as bank FDs offer capital safety, which may also be subject to certain limitations*. However, after accounting for tax and inflation, the funds may not be sufficient enough to meet the financial goals
- Fixed income funds can be a worthy alternative as they are subjected to low volatility**, reasonable liquidity^ and inflation-adjusted better performance relative to other alternatives
- They are market-linked products and invest in diverse fixed income instruments such as government securities, corporate bonds and money market instruments
- The net asset value (NAV) of a fund changes in line with the interest rate movement of underlying fixed income instruments and on rating changes of underlying issuer holdings
- Fixed income funds are ideal for risk-averse investors
- They offer variety and convenience which an investor can tailor to meet your financial goals

Bank deposits are insured up to a maximum of Rs 1 lakh by the deposit insurance and credit guarantee corporation (DICGC).

** Despite low volatility there were two instances on July 16, 2013 and July 24, 2013 when the liquid funds gave negative one-day return due to tightening of liquidity by the RBI.

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Fixed income funds versus FDs

Particulars	Fixed income funds (debt funds)	FDs
Meaning	A fixed income fund collects money from investors and puts it in various fixed income securities such as government and corporate bonds, and money market instruments.	A financial instrument provided by banks wherein money can be invested for a fixed period, earning a fixed rate of interest.
Risk / Return	Risk and returns potential is high, as they are market-linked and not guaranteed.	Low risk and returns guaranteed* (unless the bank defaults).
Withdrawal	No such thing as premature withdrawal. However, exit loads are applicable if money is withdrawn before the minimum period (except in the case of liquid funds).	Penalty for premature withdrawal.
Taxation	If holding period is less than or equal to three years, STCG is taxed as per applicable tax slab rates, while for a holding period of more than three years, LTCG is taxed at 20% with indexation.*	Interest on FDs is taxed as per the applicable tax slab of the investor.
Suitability	For investors with expectation of low to moderate but relatively above average returns compared with traditional savings alternative and at the same time do not wish their investments to subject to higher risk as in equities or other high risk asset classes.	For investors with low risk appetite and who want regular and guaranteed income to meet day-to-day expenses.

* Tax surcharge applicable.

STCG stands for short term capital gain tax

LTCG stands for long term capital gain tax,

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The diversified palette of fixed income funds

Scheme	Characteristics
Overnight fund	Investment in overnight securities having maturity of 1 day
Liquid fund	Investment in debt and money market securities with maturity of up to 91 days only
Ultra short duration fund	Investment in debt & money market instruments such that the Macaulay duration of the portfolio is between 3 months - 6 months
Low duration fund	Investment in Debt & Money Market instruments such that the Macaulay duration of the portfolio is between 6 months- 12 months
Money market fund	Investment in money market instruments having maturity up to 1 year
Short duration fund	Investment in debt and money market instruments such that the Macaulay duration of the portfolio is between 1 and 3 years
Medium duration fund	Investment in debt and money market instruments such that the Macaulay duration of the portfolio is between 3 and 4 years
Medium to long duration fund	Investment in debt and money market instruments such that the Macaulay duration of the portfolio is between 4 and 7 years.
Long duration fund	Investment in debt and money market Instruments such that the Macaulay duration of the portfolio is greater than 7 years.
Dynamic bond	Investment across duration.
Corporate bond fund	Minimum investment in corporate bonds - 80% of total assets (only highest rated in instruments).
Credit risk fund	Minimum investment in corporate bonds - 65% of total assets (investment in below highest rated instruments).
Banking and PSU fund	Minimum investment in debt instruments of banks, Public Sector Undertakings, Public financial institutions - 80% of total assets.
Gilt fund	Minimum investment in government securities - 80% of total assets (across maturity).
Floater fund	Minimum investment in floating rate instruments - 65% of total assets.
Fixed maturity plans (FMPs)	FMP is a close-ended mutual fund scheme with a fixed maturity. It invests in debt instruments that are equal to its own tenure.

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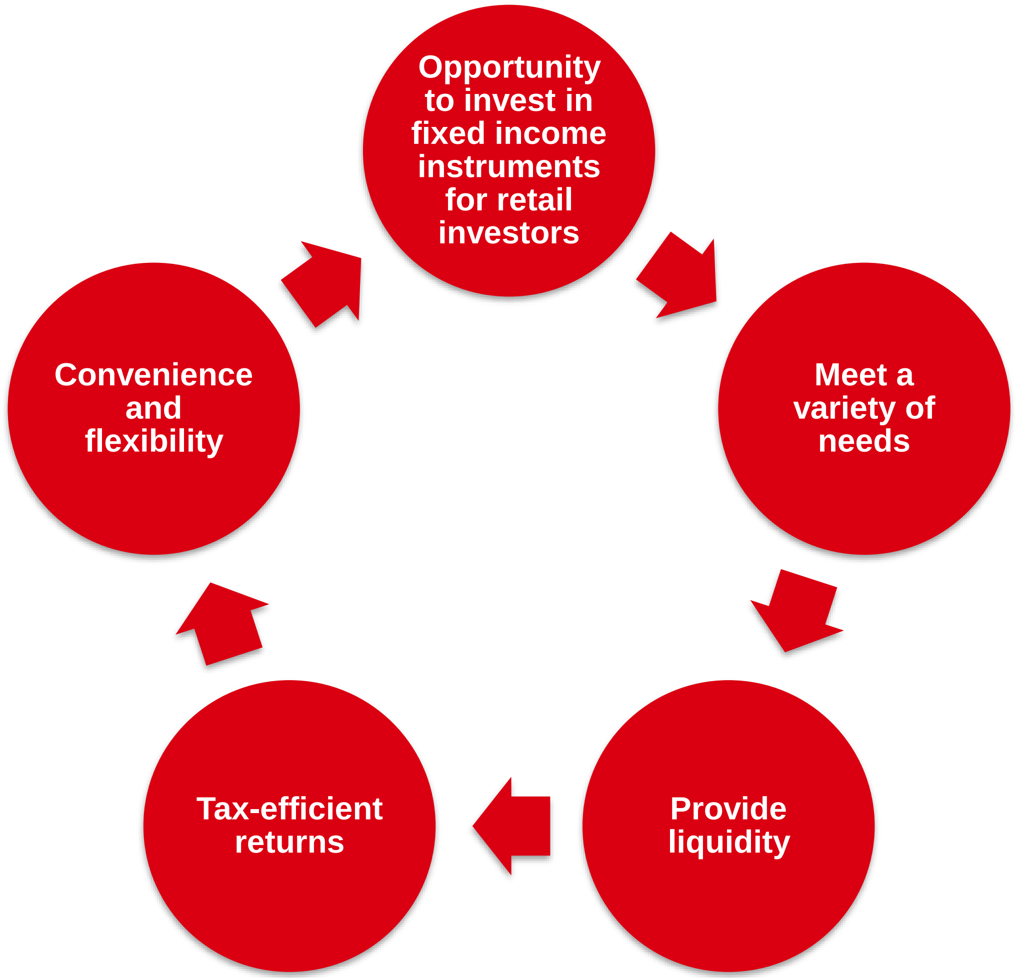
Fixed income funds - benefits



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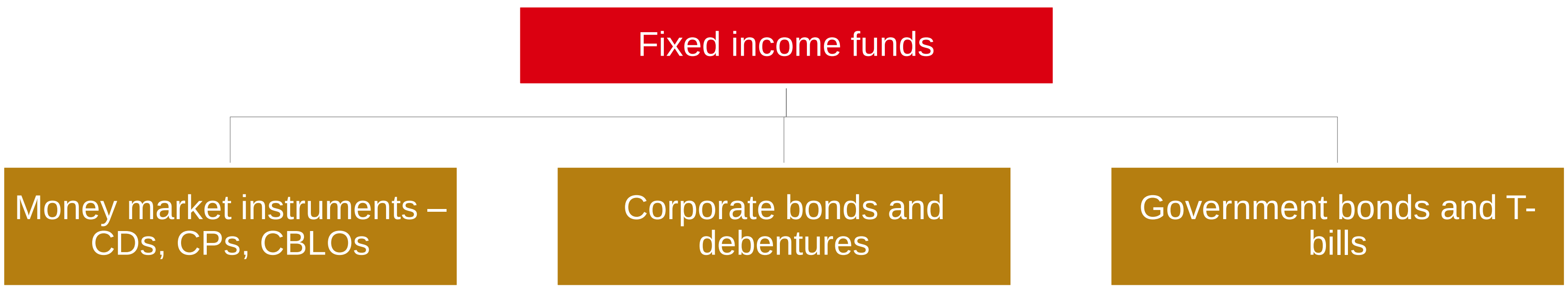
Benefit 1: Opportunity for retail investors to access fixed income instruments

- It is quite difficult for retail investors to directly invest in fixed income instruments owing to their complexity and cost factors
- Through fixed income funds, they can take exposure to various fixed income instruments across various maturities and rating profiles such as government securities, treasury bills, corporate bonds, debentures, commercial papers (CPs), certificates of deposit (CDs), collateral borrowing and lending obligations (CBLOs)
- Professional fund managers actively manage the portfolio of these instruments based on interest rate and credit management, helping investors earn market-linked returns



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Benefit 2: Meet diverse needs

- Fixed income funds offer a great variety and you can choose a particular category based on your risk appetite and investment objectives. Below are some of the major categories that you can consider:
- Liquidity-oriented funds: These funds typically invest in short-term corporate bonds, CDs, CPs, and government T-bills.
- Types of funds to manage short-term surplus money:
  - Liquid funds: They invest in fixed income instruments that have maturity of 91 days or less. They are ideal if you have a low risk profile and are planning to build a corpus for contingencies. Or they are good to meet a very short-term goal such as children's tuition fees, or settlement of one-time bills.
  - Ultra short duration funds: They invest in fixed income instruments such that the Macaulay duration^^ of the portfolio is between three and six months. These funds have potential to generate slightly higher returns than liquid funds, as the risk is comparatively higher, and are suitable if you want to park surplus funds to achieve specific short-term goals.
- Shorter duration & longer duration funds:
  - Short duration funds invest in fixed income instruments having short- to medium-term maturity. These funds perform well in a rising interest rate scenario. As you can re-invest at higher rates, they are less sensitive to interest rate changes.
  - Long duration funds invest across fixed income instruments such as bonds, corporate debentures and government securities, and take calls based on the interest rate outlook to take advantage of the rate movements. You can choose them if you have higher risk appetite as they are exposed to the interest rate risk.

^^ The Macaulay duration is the weighted average term to maturity of the cash flows from a bond. The weight of each cash flow is determined by dividing the present value of the cash flow by the price.

Benefit 3: Liquidity - get your money back on time

- Generally, liquidity refers to an investor's ability to sell the asset at the required time, keeping in mind the costs associated with it
- In the context of a fund, liquidity may refer to a fund's ability to meet your redemption request without affecting the interests of other investors
- Liquid funds offer reasonable liquidity with redemption availability on any working day*

* Notes -

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Benefit 4: Systematic features offer convenience and flexibility

- You can use systematic features judiciously in your financial planning process.

SIP	SWP	STP
An alternative to bank recurring deposit	**Regular liquidity**	**Tactical plan in asset allocation**
Many investors use bank recurring deposits as a regular saving tool.	Investors, especially retirees, need regular source of income post retirement.	Systematic transfer plan (STP) can be tactical in asset allocation between equity and fixed income funds.
Alternatively, an investor may invest small sums regularly in fixed income MFs, via systematic investment plan (SIPs).	Most invest their retirement corpus in bank deposits and get regular interest income.	For instance, it is better to invest in equity funds regularly, as against lump sums, as latter may exposed to short term volatility.
	Alternatively, investors may consider investing in a fixed income MF, and regularly withdraw a fixed sum by opting for systematic withdrawal plan (SWP).	You can invest lump sum in fixed income fund and regularly transfer a fixed sum into an equity fund. It will provide dual benefit: a) Cost averaging in equity fund; and b) relatively stable growth from fixed income fund.

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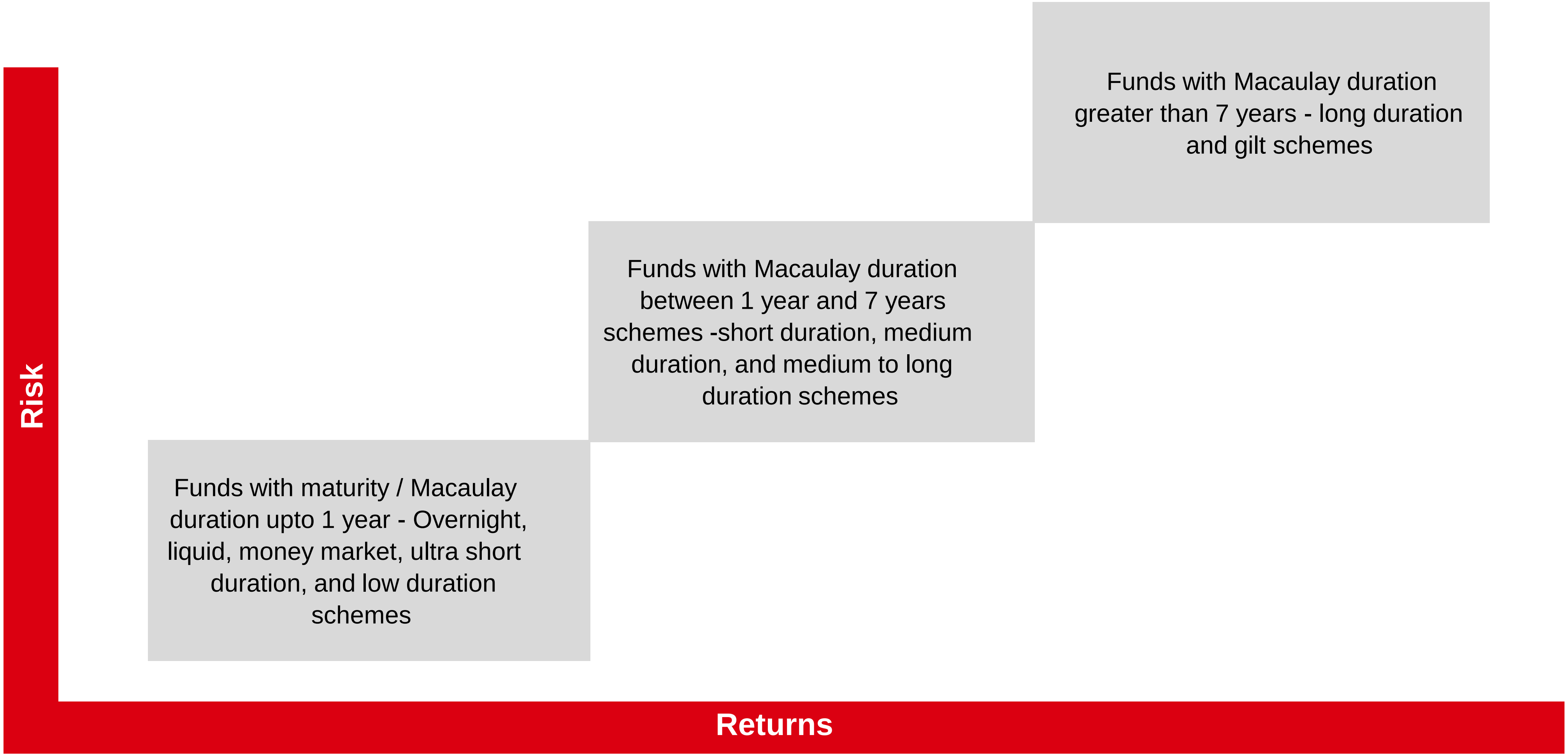
Choose a fund as per your risk-return objectives



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Note - Potential risk involved indicates interest rate risk and is not an indicator of credit risk
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Key takeaways

- Fixed income investment is a fundamental part of financial planning
- Fixed income funds are clearly emerging as potential better alternatives to traditional fixed income products
- Being market-linked products, fixed income funds have potential to generate better returns along with reasonable safety and liquidity
- They are ideal for risk-averse investors
- Their key benefits are:
    - Opportunity for retail investors to invest in fixed income instruments
    - Variety of options available; investors can choose as per their financial need
    - Liquidity
    - Tax efficiency
    - Convenience and flexibility

Notes -
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