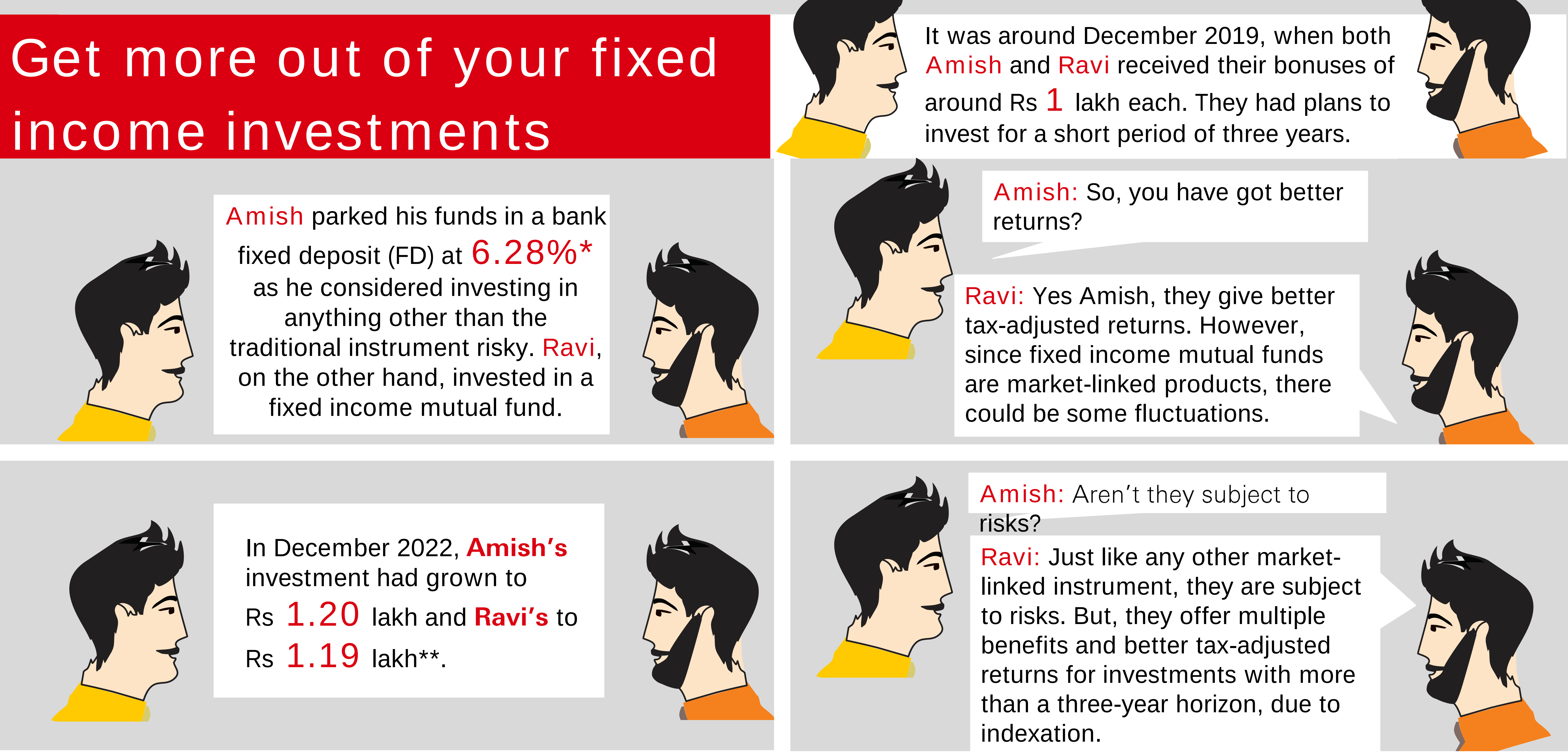
# Fixed income funds for financial planning

An Investor Awareness & Education Initiative

February 2023

HSBC Mutual Fund | Opening up a world of opportunity

# Get more out of your fixed income investments




The above data analysis/chart is for illustration only, Investment period considered is three years
* FD returns are based on three-year CAGR return of CRISIL FD index as on 31 December 2022
** Based on point-to-point three-year CAGR return of short-duration funds category represented by Crisil Short Term Bond Fund Index as on 31 December 2022
Past performance may or may not be sustained in the future.

# Get more out of debt investments

Ravi: As you can see from the table, I was able generate better returns, along with lower tax liability through indexation, thus increasing my overall returns.

| | Fixed income fund | Bank FD# |
|---|---|---|
| Amount invested | Rs 1 lakh | Rs 1 lakh |
| Holding period | 3 years | 3 years |
| Return*** | 6.08% | 6.28% |
| Investment value | Rs 1.19 lakh | Rs 1.20 lakh |
| Inflation rate of indexation | 4.63%@ | NA |
| Indexed cost of investment | Rs 1.15 lakh* | NA |
| Taxable income | Rs 4,839 | Rs 20,048 |
| Tax payable | Rs 968^ | Rs 6,014^^ |
| Post-tax gain | Rs 18,404 | Rs 14,034# |
| Post-tax return | 5.8% | 4.5% |

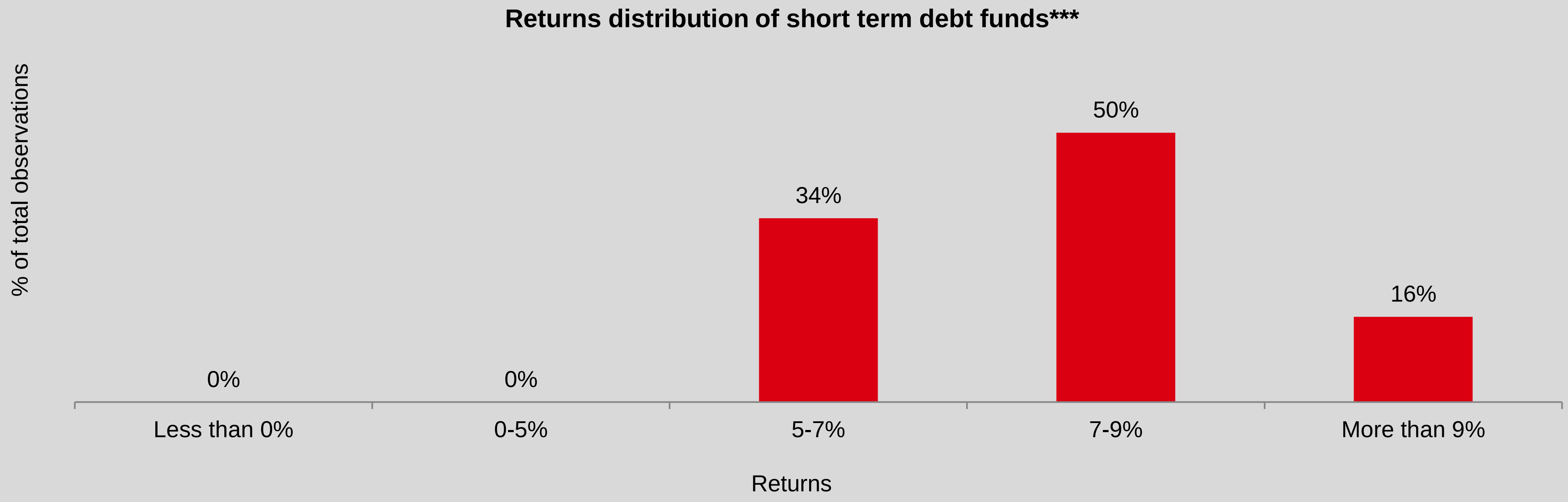
Source – CRISIL, Data as on 31 December 2022 . For illustration only
@ Cost Inflation Index (CII) is taken for the year of investment and that of the year of redemption, i.e., fiscals 2020 and 2023, respectively, and the rates used are actual rates prescribed by income tax authorities for these years
* Computed on the basis of CII (fiscals 2020-2023)
*** Fixed income fund return - Represented by three-year CAGR return of weighted average index of CRISIL ranked short duration funds category and bank FD return represented by returns are as per three-year CRISIL FD index
^ Taxed at 20% after taking into account the indexation benefit
^^ Tax on interest is payable at income tax slab rate; here, it is assumed at the highest tax bracket of 30%
# Fiver-year FDs also provide tax benefit u/s 80C IT Act. Post-tax returns may increase post addition of this benefit
As per prevailing tax laws. It is recommended to consult a financial advisor before taking any investment decision
Past performance may or may not be sustained in the future.

# 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, isn’t it?

**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, thus reducing the overall risk.

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




Source – CRISIL, The above data analysis/chart is for illustration only

*** Analysis based on three-year daily rolling returns of weighted-average index of CRISIL-ranked short-duration funds category from 1 April 2002 to 31 December 2022

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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 investments
- Interest from debt offers a periodic income
- Invest in capital market debt instruments or through debt fund categories such as duration funds, which also offer potential capital appreciation
- Fixed income funds reduce risk with diversified investments

Source – CRISIL, Past performance may or may not be sustained in the future.

# Common errors investors make with 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 compared with 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 surplus cash. Investors can instantly redeem money from a liquid fund and get a credit in the bank account by 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 until 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

Source – CRISIL, *As per prevailing tax laws. It is recommended to consult a financial advisor before taking any investment decision

** Investments in open-ended fixed income funds can be redeemed on any business day and are subject to exit load structure as the Scheme Information Documents . Past performance may or may not be sustained in the future

# 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 securities, corporate bonds and money market instruments, depending in the investment style mentioned in the scheme related documents. | 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 a premature withdrawal. However, exit loads may be applicable if money is withdrawn before the minimum period | Penalty for premature withdrawal |
| **Taxation** | If the 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 |

Source – CRISIL, ^Tax surcharge applicable
STCG - Short-term capital gain tax, LTCG - Long-term capital gain tax
* Bank deposits are insured up to a maximum of Rs 5 lakh by the Deposit Insurance and Credit Guarantee Corporation
Past performance may or may not be sustained in the future.

# 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 to meet the financial goals
- Fixed income funds can be a worthy alternative, as they are subject 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
- 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 investors can tailor to meet their financial goals

* Bank deposits are insured up to a maximum of Rs 5 lakh by the Deposit Insurance and Credit Guarantee Corporation

** Despite low volatility, there have been some instances where liquid funds have given negative one-day returns, primarily due to liquidity concerns

^Investments in open-ended fixed income funds can be redeemed on any business day. Past performance may or may not be sustained in the future

# 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 and money market instruments, such that the Macaulay duration of the portfolio is between 3 and 6 months |
| **Low duration fund** | Investment in debt and money market instruments, such that the Macaulay duration of the portfolio is between 6 and 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 in AA+ and above rated corporate bonds) |
| **Credit risk fund** | Minimum investment in corporate bonds – 65% of total assets (only in AA* and below rated corporate bonds) |
| **Banking and PSU fund** | Minimum investment in debt instruments of banks, public sector undertakings, public financial institutions and Municipal Bonds – 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 |

Source – CRISIL, * excludes AA+ rated corporate bonds, Refer to the SID of the mutual fund scheme for more details.

# Fixed income funds – Benefits


For representation purpose only, Source - CRISIL

Past performance may or may not be sustained in the future.

# Benefit 1: Opportunity for retail investors to access fixed income market

- It is quite difficult for retail investors to directly invest in fixed income instruments due to complexity and cost factors
- Through fixed income funds, they can take exposure to various fixed income instruments across maturities and rating profiles, such as government securities, treasury bills, corporate bonds, debentures, commercial paper (CPs), certificates of deposit (CDs), and 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

Fixed income funds

- Money market instruments — CDs, CPs, CBLOs
- Corporate bonds and debentures
- Government bonds and T-bills

Note - For illustration purpose only, Source - CRISIL

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# Benefit 2: Meet diverse needs — best for short-term goals

- In a rush to achieve their goals, especially short-term ones, many investors take on risk by investing in equities
- Equities face a shortfall risk, if an investment goes awry due to short-term volatility
- Relevant fixed income products, in contrast, can ensure that investors' goal is met without worry
- An analysis of fixed income funds' returns distribution (represented by the performance of short duration category), shows historically they gave 5-9% returns during 61% of time in the one-year timeframe**
- Further, the probability of loss in debt is nil compared with 20%^ in equity

**Sameer's two lives:**

Sameer needs Rs 6.80 lakh next year as part-payment for the house he has booked. Assuming he has saved Rs 6.60 lakh today for this goal:

- Investing in equities can result in a shortfall of Rs 53,000, assuming the stock market falls 5% after a year
- Investing in a fixed income fund, such as short duration fund, has the potential to ensure Sameer will meet his goal of building the Rs 6.80 lakh corpus, assuming a ~3.5% return*

Source – CRISIL, For representation purpose only.
* Based on one-year daily rolling return of weighted-average index of CRISIL-ranked short duration funds category as on 31 December 2022
** Analysis based on one-year daily rolling returns of weighted average index of CRISIL-ranked short duration funds category from April 1, 2004, to December 31, 2022
^ Calculated loss probability on basis of one-year daily rolling returns of the Sensex from April 1, 2004, to 31 December 2022
Note: The example is for illustration only
As on 31 January 2023, S&P BSE SENSEX was at 59549.9
Past performance may or may not be sustained in the future.

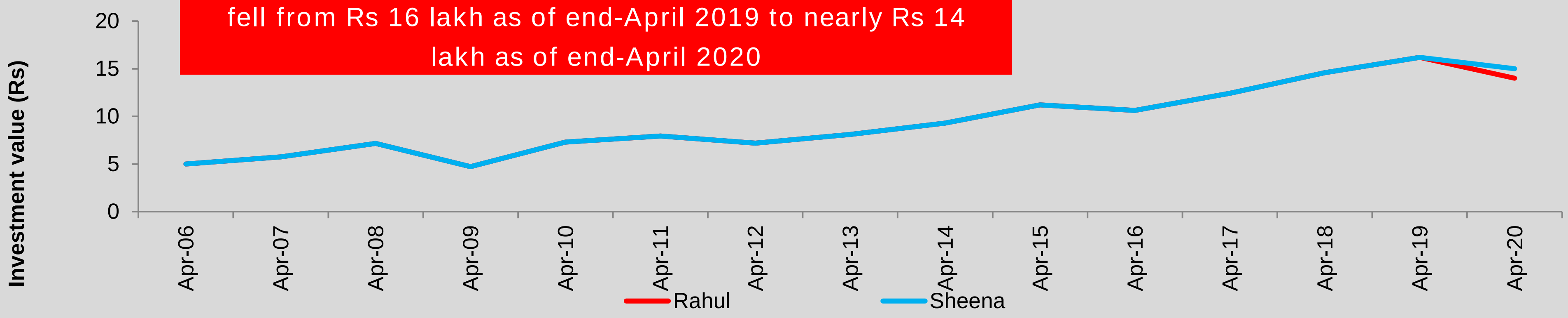
# Benefit 2: Meet diverse needs — optimum asset allocation for medium or long term

- To meet 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 deviations arising from riskier asset classes such as equity
- Rahul - Equity returns 7% (15 year CAGR), Sheena - Equity returns 5% (15 year CAGR), Debt 7% (1 year absolute return)

## Illustration

Rahul and Sheena invested Rs 5 lakh in April 2006 for 15 years in equities. Rahul stayed invested in equities during the period. In April 2019, Sheena reduced equity allocation to 70% and parked 30% in fixed income to reduce her exposure to relatively more volatile equity markets.

**Due to volatility in 2020, the value of Rahul's investments** fell from Rs 16 lakh as of end-April 2019 to nearly Rs 14 lakh as of end-April 2020




Sheena's investment grew to Rs 15 lakh in April 2020 due to diversification into fixed income in April 2019. She managed to save Rs 1 lakh more than Rahul

Source – CRISIL, Note: The above example is for Illustration purpose only
Returns of the equity asset class represented by the Sensex
Returns of the debt asset class based on point-to-point return of weighted average index of CRISIL-ranked short duration funds category from 30 April 2019 to 30 April 2020
Past performance may or may not be sustained in the future.
Note: As on 31 January 2023, S&P BSE SENSEX was at 59549.9

# Benefit 3: Liquidity – get your money back on time

- Generally, liquidity refers to an investor's ability to sell the asset when needed, keeping in mind the costs associated with the transaction
- 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*

Source – CRISIL

* Notes - Investments in open-ended fixed income funds can be redeemed on any business day.

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# Benefit 4: Systematic features offer convenience and flexibility

- You can leverage systematic features judiciously in your financial planning process

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

Source – CRISIL, For representation purpose only
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# Debt funds have benefits but are marked to market and carry certain risks

- Investors need to carefully evaluate the schemes based on underlying risk factors and map them onto their risk-return profile and investment horizon

## Interest rate risk

- Is the sensitivity of a fund's portfolio value to changes in the interest rate and measured by modified duration. Higher the fund's duration, more the exposure to the interest rate risk. Long duration funds (gilts) are more exposed to this risk than short maturity funds such as liquid, ultra-short, and short duration funds

## Credit risk

- Is the risk of default in payment of coupon and/or principal by an issuer. Lower the credit rating, higher the credit risk. Investors can mitigate this risk by choosing well-diversified funds with a higher exposure to high credit rating papers (AAA/ A1+).

## Liquidity risk

- Is the risk a fund is exposed to in liquidating invested assets in case of dire circumstances. This can be reduced by investing in funds with a better credit quality profile

Source – CRISIL, For representation purpose only.

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# Choose a fund as per your risk-return objectives

Funds with Macaulay duration greater than 7 years - long duration and gilt schemes

Funds with Macaulay duration between 4 and 7 years — medium to long duration schemes

Funds with Macaulay duration between 1 and 4 years — short duration and medium duration schemes

Funds with maturity / Macaulay duration up to 1 year - overnight, liquid, money market, ultra short duration, and low duration schemes

Risk

Returns

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.

Source – CRISIL, Note - Potential risk involved indicates interest rate risk and is not an indicator of credit risk

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HSBC Mutual Fund

# Key takeaways

- Fixed income investment is fundamental to financial planning
- Fixed income funds are clearly emerging as potentially better alternatives to traditional fixed income products
- Being market-linked products, fixed income funds have the potential to generate better returns and also provide reasonable safety and liquidity
- They are ideal for risk-averse investors
- Their key benefits are:
  - Retail investors get an opportunity to invest in fixed income instruments
  - Availability of multiple options; investors can choose in keeping with their financial need
  - Liquidity
  - Tax efficiency
  - Convenience and flexibility
- However, these funds are market-linked and investors need to evaluate the risk associated with the category and map it with their own investment objective and risk appetite
- It is crucial to choose quality funds after evaluating the credit quality of the underlying portfolio, liquidity profile, concentration of the invested papers and consistency of the performance

Source - CRISIL
Notes -
Despite low volatility, there have been some instances when liquid funds have given negative one-day returns primarily due to liquidity tightening by the RBI or recently caused by liquidity concerns amid pandemic and lockdown restrictions
Investments in open ended fixed income funds can be redeemed on any business day. Past performance may or may not be sustained in the future.
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