Fixed-income funds for financial planning

HSBC
Asset Management

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Get more out of your fixed-income investments

It was around December 2017, when both **Amish** and **Ravi** got their bonuses of around Rs **1** lakh each. They had plans to invest for a short period of three years

Amish parked his funds in a bank fixed deposit (FD) at **7%*** as he considered investing in anything other than the traditional instrument risky. **Ravi**, on the other hand, invested in a fixed-income mutual fund.

Amish: So, you have got a better return than me?

Ravi: Yes Amish, fixed-income mutual funds are market-linked products

In January 2021, **Amish's** investment had grown to Rs **1.23** lakh and **Ravi's** to Rs **1.25** lakh**.

Amish: Aren't they subject to any risks?

Ravi: Just like any other market-linked instrument, they are subject to risks. But, they offer multiple benefits and better tax-adjusted returns for investments with more than a three-year horizon, due to indexation

Investment period considered is three years

* Based on RBI FD data

** Based on point-to-point three-year CAGR return of weighted-average index of CRISIL-ranked short-duration funds category as on December 31, 2020

The above data analysis/chart is for illustration 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, thus increasing my overall return

	Fixed-income fund	**Bank FD[#]**
Amount invested	Rs 1 lakh	Rs 1 lakh
Holding period	3 years	3 years
Return***	7.70%	7.00%
Investment value	Rs 1.25 lakh	Rs 1.23 lakh
Inflation rate of indexation	2.57%[@]	NA
Indexed cost of investment	Rs 1.11 lakh*	NA
Taxable income	Rs 14,241	Rs 22,504
Tax payable^^^	Rs 2,848^	Rs 6,751^^
Post-tax gain	Rs 22,076	Rs 15,753[#]
Post-tax return	6.89%	5.00%

@ *Cost Inflation Index (CII) is taken for the year of investment and that of the year of redemption, i.e. fiscals 2018 and 2021 respectively, and the rates used are actual rates prescribed by income tax authorities for these years.

* Computed on the basis of CII (fiscals 2018-21) *** 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 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%.

[#] 5 years FD 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 financial advisor before taking any investment decisions.

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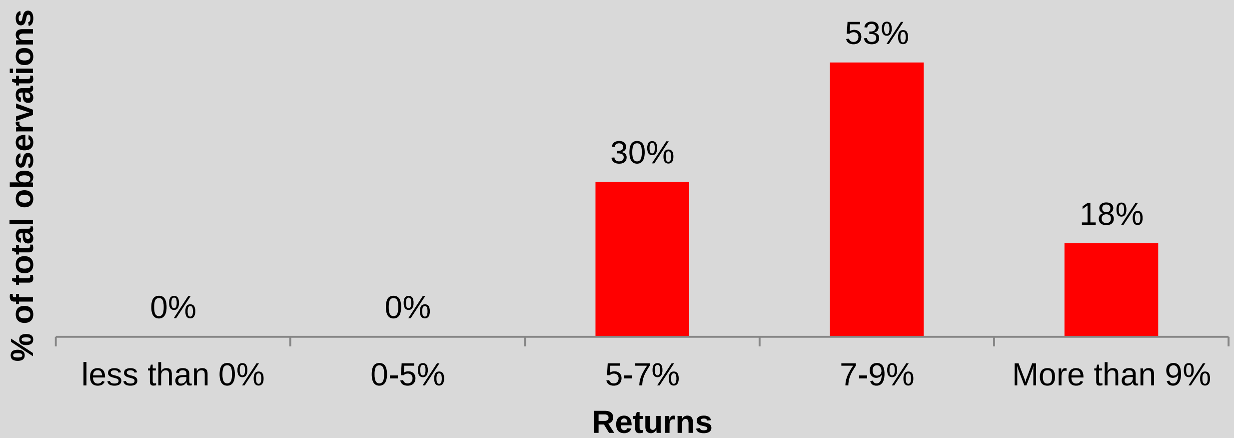
Get more out of your fixed-income investments

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, 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

Returns distribution of short-term debt funds***



*** Analysis based on three-year daily rolling returns of weighted-average index of CRISIL-ranked short-duration funds category from April 1, 2002, to December 31, 2020.

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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

The interest from debt offers a periodic income

Invest in capital market debt instruments or through debt-fund categories, such as duration funds, also offer potential capital appreciation

Fixed-income funds reduce risk with diversified investments

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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 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 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

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** Investments in open-ended fixed-income funds can be redeemed on any business day. As per the regulations, the fund shall dispatch the redemption proceeds within 10 business days from the date of acceptance of a redemption request. Under normal circumstances, the fund will endeavor to dispatch the redemption proceeds in one business day from the date of receiving a valid redemption request. 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 enough 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
- 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 5 lakh by the Deposit Insurance and Credit Guarantee Corporation (DICGC).

** Despite low volatility, there have been some instances where liquid funds have given negative one-day returns, primarily due to liquidity tightening by the RBI or recently caused by liquidity concerns, pandemic and lockdown restrictions

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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 securities, 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 a 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 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

^Tax surcharge applicable.

STCG stands for short-term capital gain tax

LTCG stands for long-term capital gain tax

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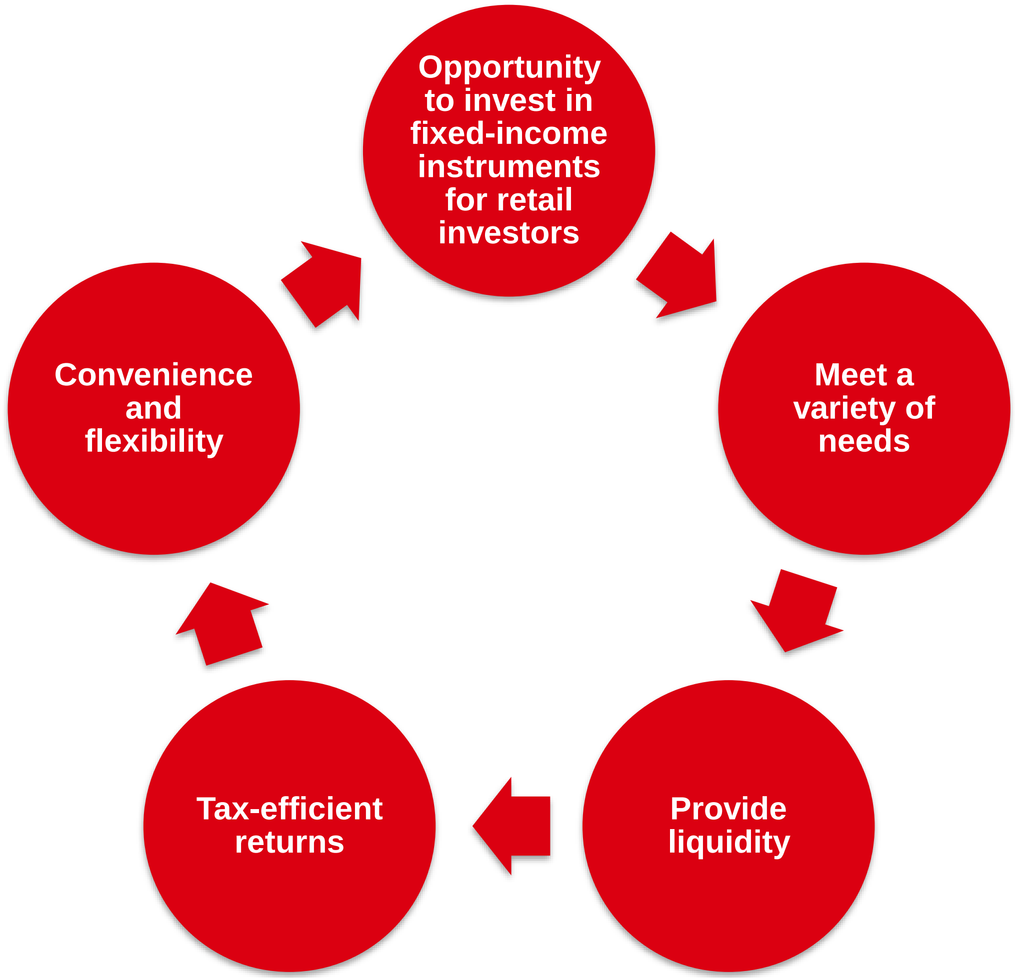
The diversified palette of fixed-income funds

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 and money-market instruments, such that the Macaulay duration of the portfolio is between 3 months and 6 months
Low duration fund	Investment in debt and money market instruments, such that the Macaulay duration of the portfolio is between 6 months 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 highest rated in instruments)
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 - 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 closed-end mutual fund scheme with a fixed maturity. It invests in debt instruments that are equal to its own tenure

Mutual fund investments are subject to market risks. Read all scheme-related documents carefully.

Fixed-income funds – benefits



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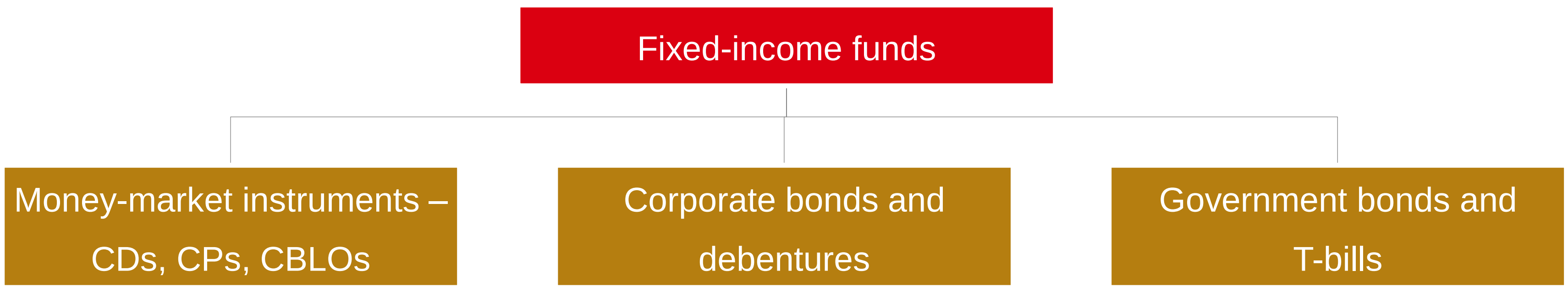
Benefit 1: Opportunity for retail investors to access fixed-income instruments

- It is quite difficult for retail investors to directly invest in fixed-income instruments, due to 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 paper (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 – 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
- This may result in a shortfall risk, if an investment goes awry due to short-term volatility
- Relevant fixed-income products, in contrast, can ensure that your goal is met without worry

Sameer's two lives:

Sameer needs Rs 7.08 lakh next year as a 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 a fixed-income fund, such as short-duration fund, has the potential to ensure Sameer meets his goal of amassing Rs 7.08 lakh, assuming a ~8.92% return*

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* Based on a one-year return of weighted-average index of CRISIL-ranked short-duration funds category as on December 31, 2020

Note: The example is for illustration only

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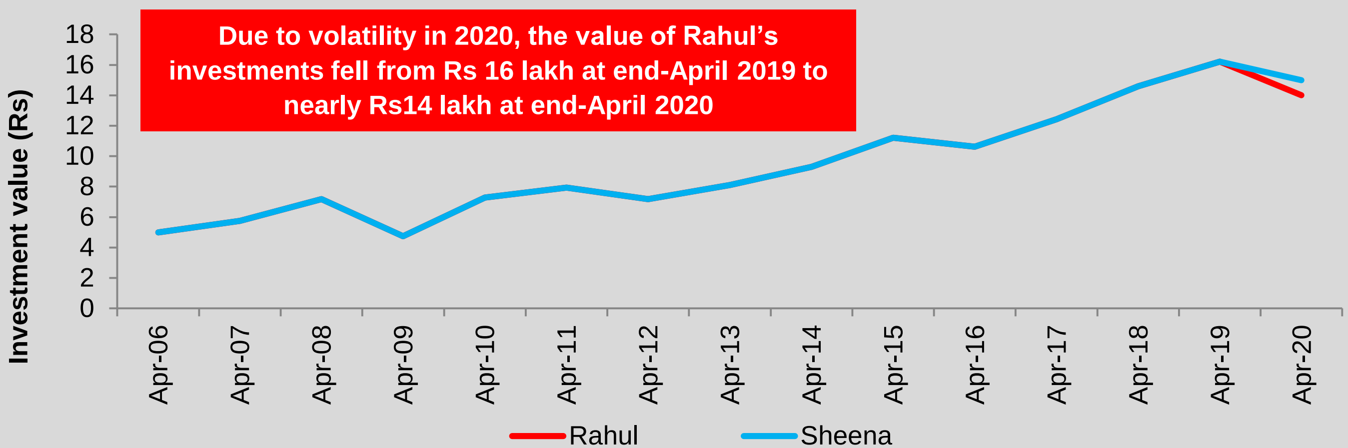
Benefit 2 - Meet diverse needs – optimum asset allocation for medium- to long-term goals

- 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 deviations arising from riskier asset classes such as equity.

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.



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

Note: The above example is for Illustration purpose only.

Returns of the equity asset class represented by S&P BSE 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 April 30, 2019 to April 30, 2020

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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*

* Notes -

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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 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 a regular source of income post 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 may be 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 lump sums in fixed income funds and regularly transfer a fixed sum into an equity fund. It will provide dual benefits: a) Cost averaging in equity fund; and b) relatively stable growth from fixed income fund.

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Debt funds have several benefits but are mark-to-market products subject to certain risks as detailed below

- 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

- It 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

- It 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

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

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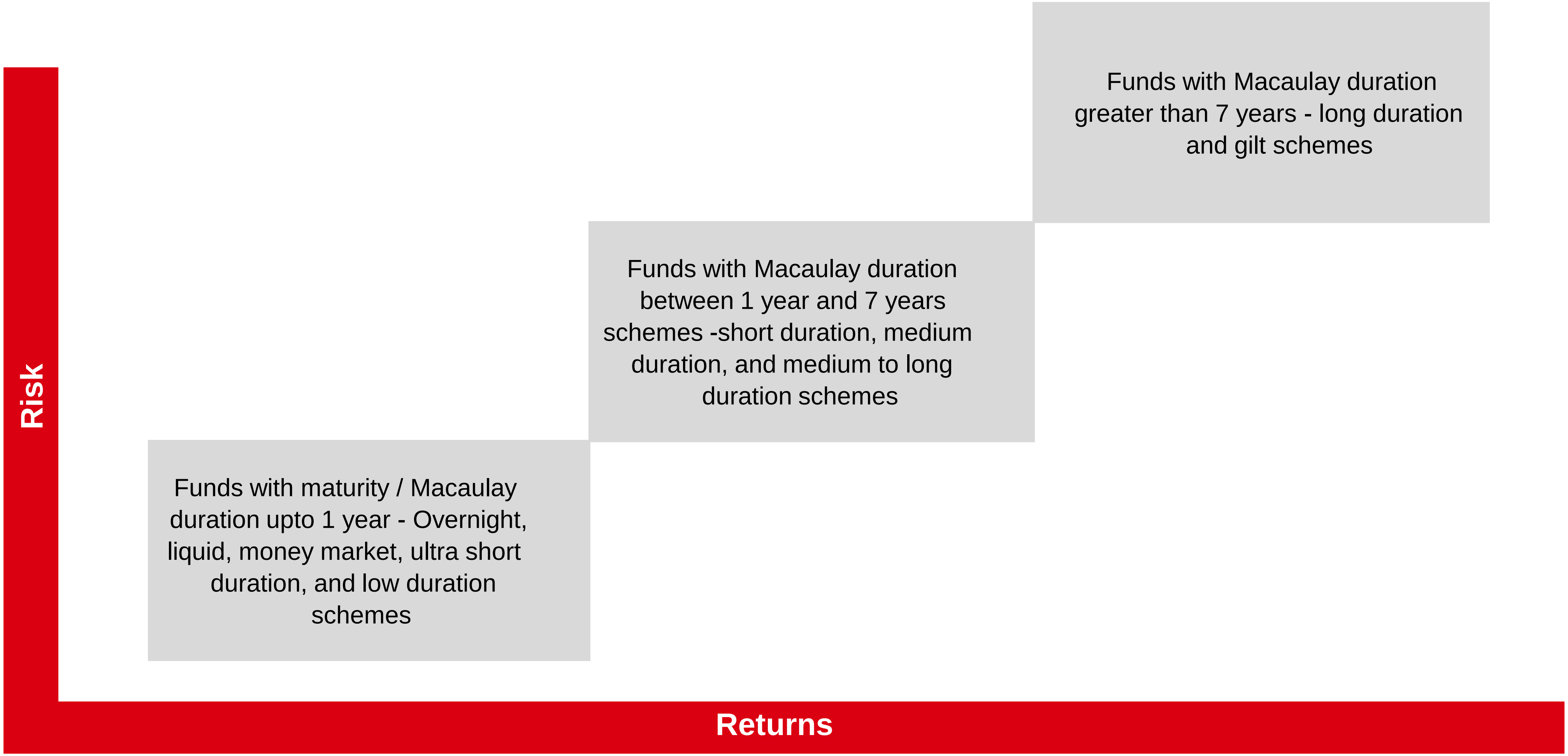
Choose a fund as per your risk-return objectives



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.

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 potentially better alternatives to traditional fixed income products
- Being market-linked products, fixed income funds have the potential to generate better returns, along with providing 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
- However, as these funds are market-linked instruments, investors need to evaluate the risk associated with the category and map it with their own investment objective and risk-taking ability
- The need of the hour is 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.

Notes -
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