Don't chase higher yields

Stick to solid banks and shun both credit and duration risk in debt funds

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Declining interest rates have got Helen Anthony, 76, a Patna-based retired school teacher, worried. "I have been rolling over my bank fixed deposits (FDs) at lower interest rates for some time now. If this trend continues, I do worry about the impact it will have on my lifestyle," she says.

Interest rates are declining, not just in India but globally, as central banks try to support faltering economies. Bank FD rates have come down. Interest on the one-year State Bank of India (SBI) FD has fallen from 7.15 per cent in September 2016 to 5.70 per cent now (6.20 per cent for senior citizens). Small saving rates were also slashed drastically for the April-June 2020 quarter. And the closure of six schemes at Franklin Templeton Mutual Fund has so dented confidence that retail investors are reluctant to invest in debt funds.

WHERE INTEREST RATES ARE STILL HOLDING UP

Instrument	Interest rate (%)	Tenure (yrs)	Taxation
GoI Savings Bond	7.75	7	Interest taxable
Sukanya Samriddhi Account	7.6	Till age 21	80C deduction; amount at maturity tax exempt
Senior Citizen Savings Scheme	7.4	5	80C deduction; interest income taxable
Public Provident Fund	7.1	15; extend in blocks of 5 yrs	80C deduction; tax exempt

Source: indiapost.org, Cleartax

Don't court extra risk: Not only are interest rates falling, they are likely to remain low in the near future. "Ultra-conservative investors, who invest only in very safe fixed-income instruments, will have to grin and bear this situation. The only silver lining is that interest rates tend to be cyclical," says Ankur Maheshwari, chief executive officer, Equirus Wealth Management.

In such a scenario, investors tend to chase products that can give them slightly higher returns. The extra risk in them is usually not justified by the additional returns. Investors should, for instance, stay away from co-operative banks. In case of debt funds, they should not opt for long-duration funds. "To earn high returns from them, you should be able to time both your entry and exit at the peak and the bottom respectively of the interest-rate cycle, which, in my view, is a near-impossible task," says Maheshwari. Any debt fund that carries credit risk needs to be shunned in this environment where many firms could default or be downgraded.

Ladder your FDs: Currently, your choice of bank should be governed by its solidity. "Park 50 per cent of your money in a solid public-sector bank like SBI and another 50 per cent in a top-rung private sector bank," says Deepesh Raghaw, founder, PersonalFinancePlan.in, a Sebi-registered investment advisor. If you do wish to start an FD with a small finance bank for their higher rates, then not more than 20 per cent of your total FD corpus should be parked with them.

Laddering means that you should invest in FDs of varied tenures so that they do not all mature at the same time—when rates are low.

Park money in sovereign-backed instruments: A considerable portion of your fixed-income allocation should be in these instruments which carry zero credit risk. Despite the drastic cut in interest rates on small-savings instruments, some remain relatively attractive (*see table*), especially those like Public Provident Fund (PPF) where the corpus on maturity is tax-exempt. There are only two issues with these instruments. Those like Senior Citizens Saving Scheme and Sukanya Samriddhi Account are available only to select groups. And they also come with considerable lock-in.

"When interest rates are declining, do not venture into instruments risks of which you do not understand fully. Don't endanger the safety of your capital just for an extra 50–100 basis points"

RADHIKA GUPTA
Chief executive officer, Edelweiss Mutual Fund

Investors may also opt for the 7.75 per cent GoI Savings (Taxable) Bonds. "Invest in them at the earliest because they could be shut down soon," says Raghaw.

Stick to safer debt-fund categories: The recent events at Franklin Templeton Mutual Fund have eroded confidence. "If investing in them will give you sleepless nights, stay away, at least until the dislocation caused by the pandemic ends," says Raghaw.

Over the longer-term, however, affluent investors may find it difficult to shun this category entirely due to its higher tax efficiency. Observe a few precautions. About 85-90 per cent of your debt fund portfolio should be in funds that do not take credit or duration risk. Categories like liquid, ultra-short duration, low-duration and money market funds will help you avoid duration risk. Make sure the portfolios of these funds do not harbour any longer-maturity bonds. As for credit risk, many debt funds are available that are 100 per cent in AAA, or 85-90 per cent in AAA and 10-15 per cent in AA-plus. Stick to them. Another safe category is banking and PSU funds. "Make sure the fund does not hold perpetual bonds," says Raghaw.

Options beyond fixed-income: Investors with some risk appetite may consider arbitrage funds. "Even if you pay a 15 per cent short-term capital gains tax on them, you are likely to earn better post-tax returns than from bank FDs or liquid funds," says Radhika Gupta, CEO, Edelweiss Mutual Fund. Park money that you can spare for more than three months and up to three years. Many arbitrage funds have considerable exposure to bonds. "Make sure the fund does not run either credit or duration risk in its debt portion," adds Gupta. She says even if there is some volatility, as we saw for a few days in March, investors are unlikely to earn negative returns from this category over a three-month period.

Investors may also opt for conservative hybrid funds, which take 10-25 per cent exposure to equities. "If you invest now, when equities have fallen, you are likely to earn fixed-income-plus returns," says Maheshwari. Invest in them only if you have the requisite risk appetite. Finally, investors may take a 10-15 per cent allocation to gold which tends to shine during economic downturns.