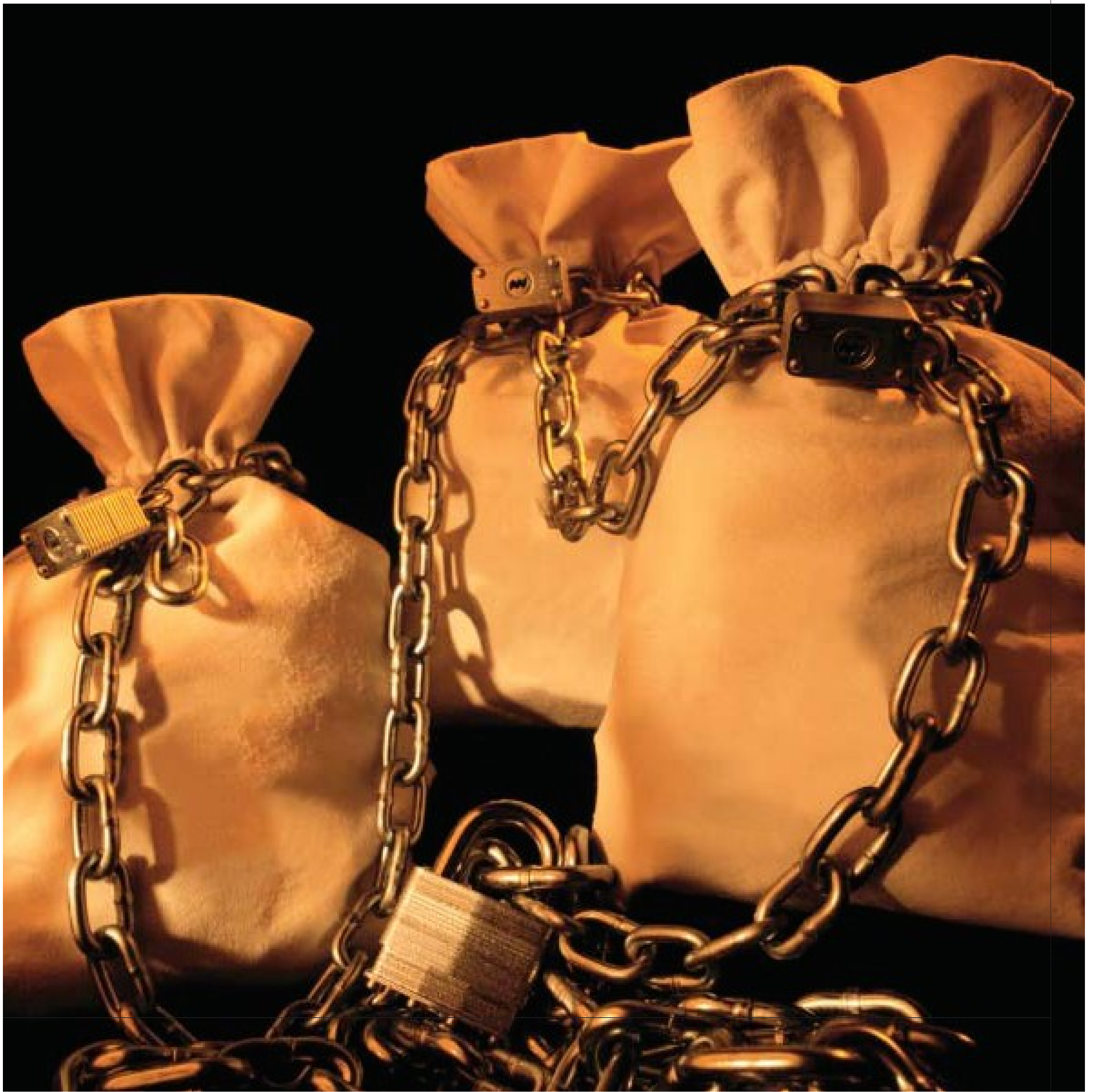
Have FDs really become "Favourable Deposits" today?

In an era of rising inflation equity market offers a better avenue for capital growth to investments compared to fixed income instruments



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"My latest bank fixed deposit gives me a risk free return of 10% p.a. for a period of one year", remarks an ecstatic Mr. Safe to his friend Mr. Gambler and his other group members, who are big time investors in the equity markets. It was really becoming difficult for Mr. Safe to hold his pleasure back while talking about his fixed deposits, especially about its ability to give risk free returns.

With this statement, Mr. Safe slowly started narrating his school of thought about the debt markets. Historically, he had never been an investor into the other asset classes apart from fixed interest bearing securities. He was happy with his investment philosophy since he was of the opinion that the same not only helped him earn a fixed (& secure) income but also a sound sleep. He did not have to worry about the volatility associated with the other asset classes such as Equity, Real Estate, Commodities etc. nor did he have to draw out the monthly status of his portfolio to gauge the gains (or losses) made during the period. Further, Mr. Safe also had the 'convenience factor' in his mind in respect of investment in Fixed Deposits. All he had to do was to visit the bank branch next door and sign a single application form. He was also happy that he did not have to suffer at the hands of the agents and their infamous mis-selling strategies.

However, Mr. Safe was reminded of the age old adage - "All good things come to an end'' around mid 2005, when the administered (by RBI) interest rates commenced their southward journey. The same fixed deposits now returned only 5% to 6% returns. During this period, Mr. Safe was enticed by the astronomical return figures and the huge dividends declared by the Equity Funds. But his apprehensions towards the risk of losing his capital and the uncertainty fluttering around the returns from the equity sector kept him away from these Funds. Consequently, such abysmal returns delivered by his fixed deposits were making Mr. Safe lose sleep.

Reminiscent of these memories, Mr. Safe is now again a happy man. It seemed to him that the friendly Governor has helped him find an answer to his questions regarding the uncertainty about the interest rate regime, by pushing the accelerator for the interest rates. With the last monetary policy announced the interest rates on deposits offered by the banks stands at almost 10.5% over the short term. Again, the five year deposits (with tax benefits attached to it) offer a rate of 8% p.a. Mr. Safe was beaming with smiles when he unfolded these investment tenets to Mr. Gambler.

All this time, Mr. Gambler had been an attentive listener to Mr. Safe's story. At the end of it, Mr. Gambler invited his dear friend's attention to the hypothesis of 'Real Returns' in the investment world. Addressing the query of one of the groupies, Mr. Gambler explained that Real Returns are nothing but the absolute returns adjusted for inflation and taxes, in other words, the return realized by a person on his investment adjusted for the taxes paid on it and the inflation existent in the economy.

By now it must have been evident that the purpose of this article is to guide an investor to find an answer to the question – Have Fixed Deposits really become "Favourable Deposits" today? considering today's euphoria for the high interest yielding Fixed Deposits. Comparatively little will be said about the other investment classes available today, with the emphasis being on the technique of analyzing the suitability of fixed deposits in one's portfolio for optimizing real returns.

Fixed Deposits – the Real Growth Rate

Talking about real returns, let's discuss the factors affecting the real returns on a financial instrument.

Inflation – no longer a silent monster

Economy experts have known for long that rising inflation is almost as predictable as increasing growth in a growing economy. Almost, every citizen of the world now knows about the 'India Shining' campaign and the conquering presence of Indian companies globally. India is definitely on a growth trajectory and it is believed that we have just started and have a long way to travel.

With such impending growth, India has not been an exception to the well accepted economic tenet, quoted as above. Along with growth, India has also embraced inflation into its fold.

Some of the inflation figures (as available publicly) for the period January 2007 to April 2007 have been noted in table 1:

Further, inflation hit its 2 year peak in the month of January 2007 when it hit a high of **6.69%**. It may be noted from the above that amidst the volatility in the inflation rates, it has consistently been above the 5.6% mark. Kindly note that the inflation figures as given above are based on particular indices, which are made up of a bunch of commodities. The actual price rise in respect of commodities that do not form a part of these indices may be higher than those indicated above.

Table 1

Week Ended	Inflation figures (in %)
20 January 2007	6.11%
27 January 2007	6.58%
7 April 2007	5.74%
20 April 2007	6.09%

Impact of Inflation on Returns

All that has been said above in respect of inflation goes a long way in reducing the yield (returns) from an investment. It is common knowledge that inflation reduces the purchasing power of the rupee. As a result, with rising inflation the returns from a fixed return instrument have to be measured in terms of returns adjusted for inflation.

In the current scenario, banks are offering deposits with rates as high as almost 10.5% for periods ranging from a year to almost 500 days. For the common man, these rates appear enticing on an absolute basis. However, it is worthy to note that rise in interest rates is a consequence of the rising inflation rates. As a result, even at 10.5% rates, the actual yield or the inflation adjusted yield is **only 4.07% p.a.** (Inflation rate taken at 5.7%, yield arrived at using the 'Real return' principle). In other words, an increase in interest rates in an era of rising inflation tends to reduce the real returns from the instrument.

Taxation – stealing the pie from the returns

In a bid to fight inflation, let us not forget that the returns from fixed deposits are taxable and with the phasing out of the investor's *favourite* Section 80 – L, there is no relief available to the investors.

For illustration purposes, we have considered the tax rates at the maximum marginal rate of 30% (excluding surcharge and education cess). The real returns from the fixed deposits (as calculated above) adjusted for taxes would yield a net return of 2.85% p.a.

Briefly, the real return has been calculated in table 2:

As deduced above, the fixed deposits yielding an absolute return of 10.5% p.a. actually yields a real return of 2.85% p.a.

Comparison With Olden Times

The tables above talk about one side of the story, i.e. about the time when the interest rates have risen. Statistically speaking, in order to have a better comparison, we also need to check the returns derived from fixed deposits before the increase in interest rates were triggered *(Table 3)*.

Table 2

Particulars	Rates
Rate of return (as provided in the Deposit Certificate)	10.50%
Inflation Rate	5.70%
Rate of return adjusted for inflation	4.07%
Tax rate	30.00%
Return adjusted for taxes	2.85%

No doubt, the new age deposits are certainly yielding better real returns than their old age counterparts. But is this increase commensurate?

Let's check this (again) by using some statistics:

As may be elicited from the above, the growth in the yield to the investor has been at a rate lower than the increase in the nominal interest rates.

Even if one does not get into the argument of whether the growth in these rates has been commensurate or not, it may be noted that these return figures may appear attractive or at least satisfactory for investors looking forward to protection or preservation of their capital invested. In case of investors looking for growth of their capital invested, other asset classes offer better opportunities to them.

Table 3

Particulars	Rates
Rate of return (as provided in the Deposit Certificate)	6.00%
Inflation Rate	4.00%
Rate of return adjusted for inflation	1.92%
Tax rate[1]	12.00%
Return adjusted for taxes	1.69%

As pointed out earlier, this article does not envisage discussing the various investment alternatives available to an investor today. At the same time, to enumerate, some principles as applicable to investing in 'Equity Class' are discussed herein.

Table 4

Particulars	New Rates	Old Rates	Increase (in %)
Interest Rates	10.50%	6.00%	75%
Inflation Rates	5.70%	4.00%	43%
Real Returns	2.85%	1.69%	68%

Equity – Ownership of Business & Not Mere Speculation

By far, the common ideology in relation to investing in equity shares is to consider shares as objects of making fast (& easy) money. This ideology ignores the fundamental fact that owning an equity share is having an ownership interest in an actual business, with an underlying value that does not depend on its share price. The past three to four years have seen a tremendous boost to the share market, with several people even having forgotten the debt sector during this period.

Investing in Indian Equity implies participation in the growth story of the Indian companies or the Indian economy. Facts and figures, released by the Indian Government, are indicative of the fact that the Indian economy is on a roll now and that India has just started its journey on the growth trajectory. The huge amounts of Foreign Direct Investment (FDI) in the various sectors such as Telecom (the recent Vodafone-Hutch deal), Retail (Bharati - Walmart venture) among others also corroborate the view on the tremendous prospects of the Indian Economy. The Indian corporate sector too, on its part is increasing its exposure to the global economy through various mergers and acquisitions in foreign. In other words, the spirits of the Indian economy are on a high note. Taking these factors into account, market experts are of the opinion that despite the short term volatility in the equity markets, one can expect to earn a modest return of 15 – 16% p.a. from this asset class.

At the same time, equities are regarded as one of the best friends of an investor to combat inflation and still provide for capital growth. On the other hand, the current Indian tax laws also (in a way) encourage equity investment as the dividend income earned is tax-free in the hands of the investors. There are concessions available for the taxes on the capital growth as well.

I do not wish to assert that the equity markets would yield 30 – 40% returns on a year on year basis, as it has done over the last three to four years. However, if somebody is looking for a capital growth to his investments, it may be better to stay away from fixed income instruments, especially in an era of rising inflation levels in the economy.

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