

# THE BEST DEBT OPTIONS FOR YOU

The hike in interest rates and inflation have pushed up bond yields. Here's how to tweak your debt portfolio | **By Tanvi Varma**

**T**he biggest spendthrift in the country has promised to mend its profligate ways and live within its means. The budget proposes to reduce the fiscal deficit from 5.5% of GDP to 4.1% by 2011-12. This means that the government, which is the largest debtor in the country, will borrow almost Rs 50,000 crore less in 2010-11 than it did in the previous financial year.

What does this mean for your debt investments? On the face of it, reduced government borrowing should translate into lower bond yields because the dip in the supply of treasury bonds would push up their prices. Bond prices move inversely with yields—if yields go up, prices fall, causing the net asset values (NAVs) of debt funds to go down. This is what happened when the budget was announced. The 10-year government security (g-sec) yields declined by a few basis points and debt fund NAVs rose smartly.

However, since then, it has been a northward journey for bond yields. In mid-March, a few days before the RBI hiked the repo and reverse repo rates by 25 basis points, the 10-year benchmark yield crossed 8.25%, the highest since October 2008. This is because the RBI also issues bonds other than those accounted for in the government's borrowing programme. Besides, the inflationary effect of the budget has hit home. "The benchmark yields are being driven upwards by the supply of government bonds as well as fears of rising inflation and interest rate hikes," says Ashish Nigam, head, fixed income, Religare Mutual Fund.

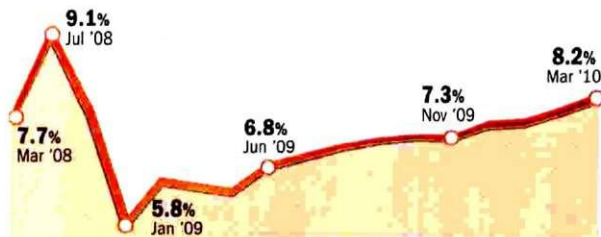
Experts don't rule out a further hike in key policy rates if inflation does not subside. In the short term—over the next 3-4 months—bond yields could rise to about 8.5%, says Murthy

**Over the next 3-4 months, bond yields could rise to 8.5%, so the debt funds holding long-term bonds could lose money.**



Illustration: RAJ

## AVERAGE YIELD ON A 10-YEAR GOVERNMENT BOND



Nagarajan, head, fixed income, Tata Mutual Fund. So, the debt funds holding long-term bonds could witness volatility or lose money in the short term. If your investment tenure is short (six to eight months), opt for short-term debt funds that offer annual returns of 6-6.5%, says Nagarajan. For shorter tenures, consider liquid plus funds, which offer annual returns of about 4.5%.

## 25 basis points

was the hike in repo and reverse repo rates announced by the RBI on March 19.

While debt funds are in a tizzy because of rising yields, fixed deposits, especially corporate deposits, may appear more attractive. This is mainly because the budget has raised the post-tax yield of fixed deposits. If your annual income was between Rs 5 lakh and Rs 8 lakh a year, a fixed deposit offering an interest rate of 7% gave a post-tax yield of 4.9% in 2009-10. From this year onwards, thanks to the broadening of tax slabs, the post-tax yield will rise to 5.6%. For taxpayers with incomes below Rs 5 lakh, the post tax-yield would be even higher at 6.3%.

Even so, fixed maturity plans (FMPs) of mutual funds continue to be better bets than fixed deposits. If held for over a year, the income from FMPs is treated as long-term capital gains and taxed at 10%. The yield from FMPs generally mirrors the prevailing bond yield (8.25%) because these funds buy securities and then hold them till maturity. The post-tax yield comes to over 7.25%, making this a more tax-efficient option than fixed deposits.

What's more, if an investor holds an FMP for more than one year, he can also claim indexation benefit. In some cases, this can get reduced to zero. But keep in mind that FMPs of more than 12 months may take you into the Direct Taxes Code territory. If the FMP you buy is scheduled to mature after April 2011, the tax on income and the indexation benefit will be as per the provisions of the DTC.

Though fixed deposits and FMPs are good options

## PERFORMANCE OF DEBT FUNDS

FUND	RETURNS (%)		
	1 YEAR	3 YEARS	5 YEARS
Gilt funds—medium & long-term	2.95	7.60	6.16
Income funds—medium & long-term	5.54	7.30	6.24
Liquid plus funds	4.79	7.13	6.59
Short-term funds	6.17	8.75	7.50
Floating rate—long-term funds	5.49	7.51	6.82

Data as on 10 March. Source: Value Research

now, after a few months, the situation may change in favour of debt mutual funds. Nagarajan points out that almost 70% of the government's borrowing programme takes place in the first half of the financial year. During this period, tax collections are low due to the slack season and the government borrows aggressively, thereby taking the yields up. Thereafter, the yields start softening as government borrowing starts winding down.

Also, inflation may calm down to 5-6% due to the high base effect in June-July and ease the pressure on interest rates. Experts say that it may be a good time to enter income and gilt funds when bond yields touch 8.5%. Things may improve further if the monsoon does not play truant as it did in 2009.

Owing to these factors, the 10-year benchmark yield is expected to trade in the range of 7-8%. "Since we do not see any spectacular change in the g-sec yields, an investor could expect returns of 9-10% from income and gilt funds," says Nagarajan. This is lower than the 25% delivered by the average medium- and long-term gilt fund in 2008, but significantly higher than the -7% clocked by the category in 2009.

If you want to tide over the volatility in the bond



**As no dramatic changes are expected in g-sec yields, investors may expect returns of 9-10% from income funds.**

MURTHY NAGARAJAN HEAD, FIXED INCOME, TATA MUTUAL FUND

yields but don't want to invest in tax-inefficient fixed deposits, you could turn to floating rate instruments. "One should ideally go for instruments with floating rate returns at the current juncture," says Anil Rego, CEO and founder, Right Horizons, a wealth management firm. These could be floating rate funds that invest in bonds where the coupon rate is linked to the prevailing benchmark yield. This is why these funds are not affected by changes in interest rates. The category has given annualised returns of 7.5% in the past three years and 8.5% in the past one year. Some banks like the Indian Overseas Bank and non-banking finance companies such as HDFC also offer floating rate deposits.