

Why Liquid Funds Still Score over Savings Deposits

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Better post-tax returns make liquid, liquid plus funds attractive despite savings rate deregulation

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Finally, the Reserve Bank of India has freed interest rates on savings bank accounts. Predictably, banks have started offering better rates (6%) on savings accounts, mostly for amounts exceeding ₹1 lakh. Does this mean investors who park their spare cash in liquid and ultra short-term bond funds (or liquid plus funds) should abandon the practice?

"Liquid and liquid plus funds are still good options to keep your idle cash due to the higher returns on offer and a better tax treatment, compared with the interest on savings bank account," says Pankaj Mathpal, managing director, Optima Money Managers.

According to Value Research, a mutual fund tracking agency, the category of liquid funds delivered 8.26% in the past year and liquid plus funds as a category delivered 8.55% during the same period. To get a better idea, take a look at how they performed in the short term.

Liquid and liquid plus funds' categories delivered 0.73% and 0.72% last month. Compare this with what the savings bank account has started offering and you will get a better picture of the situation. Some banks like Yes Bank, Kotak Bank and IndusInd



Dividend Option Better in Liquid Funds

Liquid and liquid plus funds offer better post-tax returns than a savings bank account

Returns from these funds likely to be steady as call money markets rate are expected to remain firm

Dividend option is better for short-term investors

Liquid plus funds more tax efficient than liquid funds

Use the online mode to invest in liquid and liquid plus funds, as it ensures easy access

How Liquid Funds Have Performed

LIQUID FUNDS	RATING	1 WEEK	1 MONTH	3 MONTHS	6 MONTHS	1 YEAR
Escorts Liquid Fund	★★★★★	0.19	0.82	2.48	5.09	10.22
Baroda Pioneer Liquid Fund	★★★★★	0.17	0.77	2.26	4.51	8.61
Birla Sunlife floating rate ST	★★★★★	0.17	0.74	2.20	4.49	8.61
JM High Liquidity Regular	★★★★★	0.17	0.76	2.23	4.49	10.22
Magnum Instacsh Liquid Floater	★★★★★	0.17	0.73	2.16	4.38	8.65
Quantum Liquid Fund	★★★★★	0.16	0.73	2.15	4.37	8.47
Sahara Liquid Fixed Pricing	★★★★★	0.17	0.74	2.21	4.48	8.89
Sahara Liquid Variable Pricing	★★★★★	0.17	0.74	2.21	4.49	8.94

ULTRA SHORT TERM BOND FUNDS (LIQUID PLUS FUNDS)

Baroda Pioneer Treasury Advantage Regular	★★★★★	0.18	0.77	2.29	4.61	8.80
Kotak Floater - LT	★★★★★	0.17	0.75	2.28	4.62	8.92
Sahara Short Term Bond	★★★★★	0.17	0.74	2.21	9.17	13.71
Tata Floater	★★★★★	0.17	0.77	2.29	4.61	8.95
Taurus Ultra Short Term Bond Retail	★★★★★	0.18	0.79	2.36	4.79	8.80

Returns in %, as on Nov 4, 2011

SOURCE: VALUE RESEARCH

Bank have hiked the interest rates on savings bank account to 6%. This is definitely better than the that savings bank accounts have been earning till the rate deregulation. Still, the returns lag short-term funds.

DON'T GO BY RATES ALONE

However, focusing on the rates alone could be a mistake. This is because the interest on savings bank account is assured. But that is not the case with the liquid and liquid plus funds. These funds invest in call money market and short-term papers and the NAV

keeps moving up with the accrued interest. A liquid fund manager will invest in debt instruments with less than 90 days' residual maturity.

In liquid plus fund, the fund manager may have instruments with longer maturity to make extra returns, which, of course, comes at an extra risk. Put simply, the returns from these funds will be in line with the prevailing short-term interest rates. However, there is good news.

"Given the government's borrowing programme, liquidity in the system is expected to remain

low, which will ensure that the short-term rates, especially in the call money market, remains firm," says Yadnesh Chavan, fund manager — fixed income, Mirae Asset Mutual Fund.

The government has been borrowing from the financial markets to fund its widening deficit, and this has impaired liquidity in the banking system.

Since bankers don't see improvement in the liquidity situation in the near future, short-term instruments such as certificates of deposit may continue charging firm rates. That makes

a strong case for liquid and liquid plus funds since they primarily invest in short-term papers and call money markets.

PAY ATTENTION TO THE TAX ANGLE

The dividend distribution tax (DDT) on liquid funds is 27.03% whereas the DDT on liquid plus funds is 13.52% for individual investors. The interest on savings bank account is, however, added to an individual's income and taxed at the rate applicable to the individual. This means if you are in the higher tax bracket, you will pay a tax of 30.9% on your interest from savings bank account.

"The favourable tax treatment means the post-tax returns on liquid and liquid plus funds are likely to be higher than the interest earned on savings bank account," says Mathpal.

Generally, idle cash is parked for a short term. Hence, for those investing in liquid funds, it makes sense to be with the monthly dividend option. You may choose the dividend reinvestment option to keep the money invested. In all the other cases, your dividends are credited to your bank account electronically if you have chosen that option.

NEVER LOSE SIGHT OF YOUR GOAL

Now, the big question: Why do you keep liquid cash? The answer is simple — at least in the case of most people. One, we must set aside some money for any emergency. The other situation when you are sitting on cash is when you have sold some of investments and are looking for the right time to deploy your funds in the market.

"In the case of an emergency fund, more than returns, safety and accessibility are of higher importance. One can access his/her money in a savings bank ac-

count even at night, using internet banking, but an investment in liquid fund will be available only the next day," says Mukund Seshadri, founder-partner, MS Ventures Financial Planners.

The worst situation will be when you have to start looking for your agent to redeem your investments in liquid and liquid plus funds. Of course, there are options like online investments that offer access to your money at the click of a button.

Experts may stand divided on which option should be used for maintaining emergency funds, but liquid and liquid plus funds remain the best option to keep idle cash otherwise for two reasons. Firstly, you can earmark the money in a fund for a specific purpose, but that won't be the case with the money kept in a savings bank account. Secondly, transactions in relation to these funds are easy.

You can invest in liquid funds and liquid plus funds through online platforms or your stock broker. If after selling your shares, you are expecting a large sum and you want it to be invested in liquid and liquid plus funds, then you can do it through the same broker handling your stocks. This will help you save the time involved in transferring funds from the broker to the bank and then to the liquid fund, and also maximise returns.

Of course, before investing in a liquid and liquid plus funds through any third-party distributor, it is better to ensure that there are no charges on such transactions.

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