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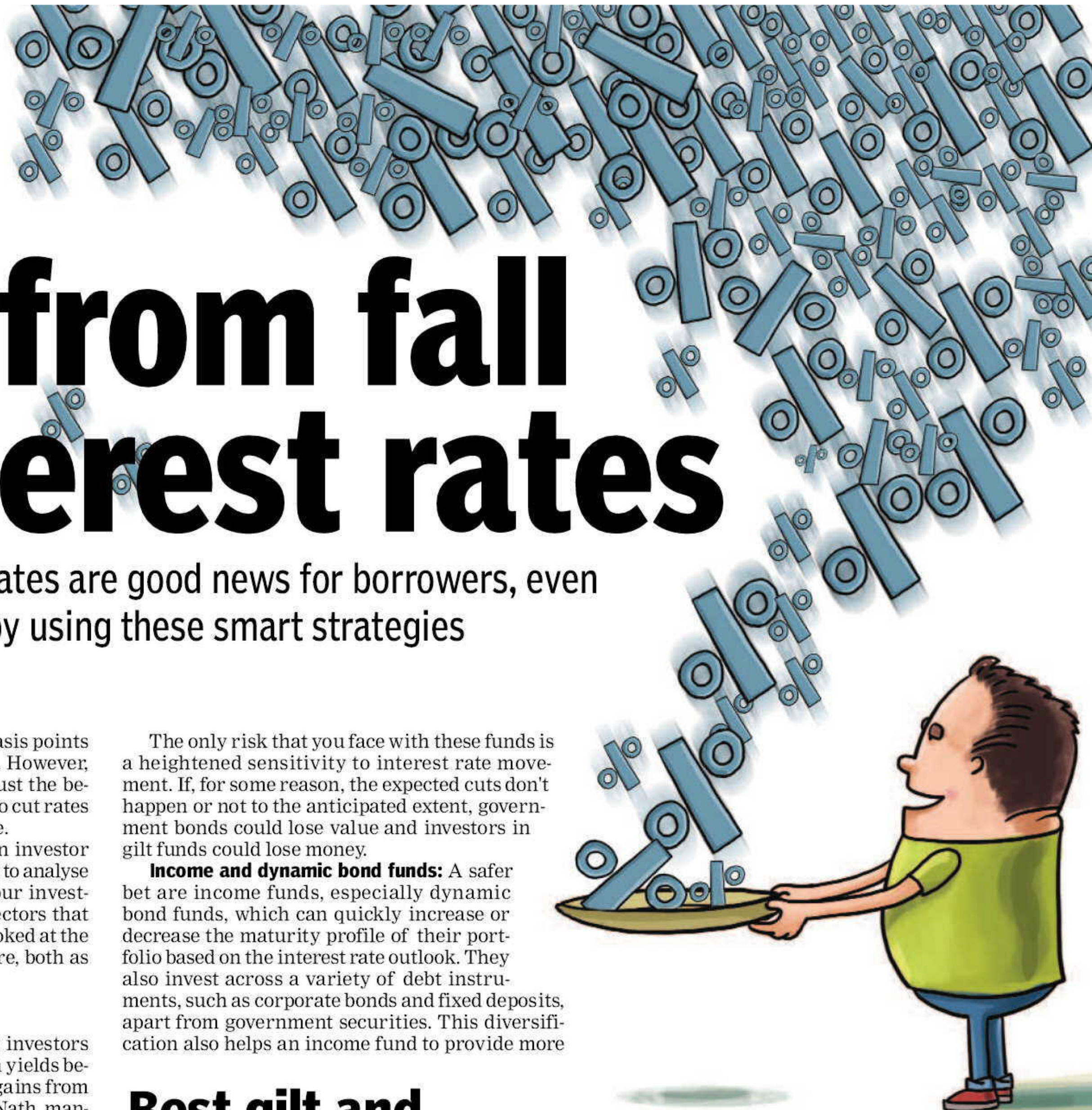

Gain from fall in interest rates

While falling interest rates are good news for borrowers, even investors can benefit by using these smart strategies

SANKET DHANORKAR

The cut in the repo rate by 25 basis points did not surprise the markets. However, analysts believe that this is just the beginning and the RBI is likely to cut rates further in the months to come.

How will the rate cut affect you as an investor and a borrower? We reached out to experts to analyse how lower interest rates will impact your investments. We analysed the products and sectors that will benefit if rates are eased. We also looked at the strategy you should adopt at this juncture, both as an investor and a borrower.

Your investment strategy

The start of monetary easing provides investors not only an opportunity to lock in at high yields before rates are cut, but also enjoy capital gains from the resulting rally in bonds. Raghvendra Nath, managing director, Ladderup Wealth Management, says, "If the rate cycle turns as expected, a similar opportunity may not come by for years."

Of course, your investment decisions should be guided not only by the expected return but also by your needs for regular income, safety of capital and liquidity. A bank deposit or a government-backed instrument, such as the PPF or NSC, is very safe. But a debt fund offers greater liquidity. The tax efficiency of the instruments is also important. See how your choices measure up on these parameters.

Debt funds are not very popular with retail investors because they don't offer assured returns. Yet, given the impending cut in interest rates, these funds may be the best option for small investors today. They can earn you a higher return than a bank FD. Although bond yields have dropped significantly in recent weeks, experts believe there is still scope for a rally in bond prices.

Long-term debt funds: Within bond funds, long-term debt funds are a more attractive proposition. If interest rates fall, these funds will witness a more pronounced capital appreciation. These funds are more sensitive to fluctuations in rate movements than short-term funds.

Gilt funds: If the reversal plays out as expected, gilt funds are likely to offer the best rewards. These schemes invest in government securities (or gilts) and, therefore, have very high-quality portfolios. As mentioned earlier, the yields of long-term government bonds have softened, which bodes well for long- and medium-term gilt funds. Aided by the rally in bond prices, gilt funds have managed to deliver double-digit returns over the past year.

The only risk that you face with these funds is a heightened sensitivity to interest rate movement. If, for some reason, the expected cuts don't happen or not to the anticipated extent, government bonds could lose value and investors in gilt funds could lose money.

Income and dynamic bond funds: A safer bet are income funds, especially dynamic bond funds, which can quickly increase or decrease the maturity profile of their portfolio based on the interest rate outlook. They also invest across a variety of debt instruments, such as corporate bonds and fixed deposits, apart from government securities. This diversification also helps an income fund to provide more stable returns, says Nath. Income funds have been the best performing debt funds in the past year (*see table*) because they had increased their portfolio maturities in the past few months.

Tax-free bonds: Tax-free bonds do not offer any tax deduction to investors, but the interest is tax-free, which makes them very attractive for those in the higher tax slabs of 20-30%. While the coupon rate of 8% is lower than that offered by bank fixed deposits, the post-tax yield is much higher. The income from a fixed deposit is fully taxable. The post-tax returns from a fixed deposit that offers 9% is only 6.3% for someone with an annual income of over ₹10 lakh. For those earning ₹5-10 lakh a year, the 20% tax will pare the yield of the fixed deposit to 7.2%. Keep in mind that the tax is payable on an accrual basis every year even if you have opted for the cumulative option.

Most of the tax-free bonds have high credit rating, which means the risk of default is very low. The tenure of these bonds is 10-15 years, so it gives investors an opportunity to lock in for a fairly long period. The best part is that these can be traded in the secondary debt market. You can cash out after a few years. If interest rates are down by then, you will pocket a neat sum in capital gains as well.

Fixed deposits: For those in the lower income brackets, bank and corporate deposits are a better option. Banks and companies are offering attractive rates on fixed deposits, but this could change in the next few months. Don't be lured by very high rates of short-term deposits. A 6-9 month deposit could offer you up to 9.5%, but there is a very high reinvestment risk. When the deposit matures, you will not be able to reinvest the proceeds at a high rate. It's best to opt for a longer duration so that you can benefit from the high rates for the rest of the tenure. However, only a few banks offer fixed deposit tenures of 8-10 years. The deal is sweeter for senior citizens, who get 0.25-0.75% higher interest on their deposits.

Recurring deposits: If you don't have a large sum to put away in a fixed deposit immediately, consider starting a recurring deposit, where you invest a fixed sum every month. Once you start a recurring deposit, the rate remains uniform for the rest of the tenure. However, unlike fixed deposits, you can't just walk into any bank and open a recurring deposit. Banks insist that you have a savings bank account with them from which a fixed amount will move to the recurring deposit every month.

Best gilt and income funds

GILT FUNDS	1-year return (%)	Average maturity (years)
L&T Gilt - Investment	14.9	13.48
IDFC G Sec PF – Plan A	13.3	14.64
Kotak Gilt Invest Regular	13.3	15.32
IDFC G Sec Investment-Plan A	13.0	14.51
Reliance Gilt Securities Fund	12.0	14.79

INCOME FUNDS	1-year return (%)	Average maturity (years)
ICICI Pru Multiple Yield - Plan E	16.5	1.39
SBI Magnum Income	12.8	13.05
Sundaram Bond Saver	12.3	4.47
Kotak Bond Fund - Plan A	12.3	10.53
IDFC Dynamic Bond - Plan A	12.2	13.64

Short-term bond funds gave good returns in 2012 because of the volatility in bond prices. However, now that the bond yields are down, long-term funds are giving better returns.

Source: ETIG Database. Data as on 21 Jan 2013

Best bank fixed deposits

Lock into long-term deposits before banks cut rates

5 YEARS

Bank	Rate (%)
Lakshmi Vilas Bank	9.50
J&K Bank	9.50
Karnataka Bank	9.50
SB of Bikaner & Jaipur	9.50
Vijaya Bank	9.30

MORE THAN 5 YEARS

Bank	Rate (%)
Tamilnad Mercantile Bank	9.50
SB of Bikaner & Jaipur	9.30
Karnataka Bank	9.25
Vijaya Bank	9.25
Karur Vysya Bank	9.25