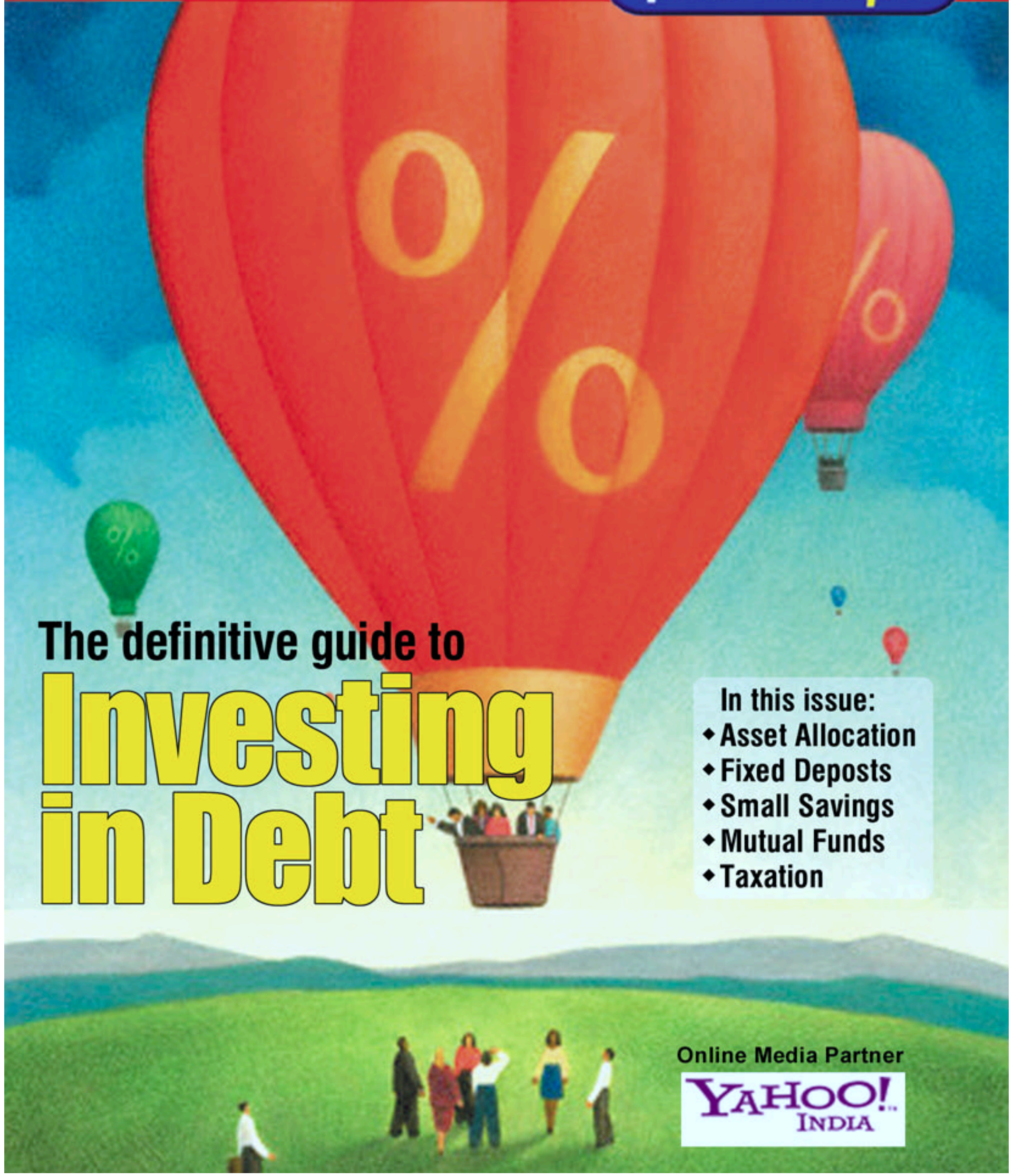
Money Simplified

VOLUME XXXIV JUNE 2007 personalfn



The definitive guide to

Investing in Debt

In this issue:
- Asset Allocation
- Fixed Deposts
- Small Savings
- Mutual Funds
- Taxation

Preface

Money Simplified

The definitive guide to investing in debt

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Debt is hot! - that's what most analysts, personal finance magazines and newspapers would like you to believe. Well, is it? Like most asset classes, debt has also witnessed a cyclical trend and looks geared to make a comeback of sorts. But that's just one part of the 'debt story'; there are other more critical aspects that are usually ignored in every 'next big story'. It's no different this time around.

As an asset class, debt merits inclusion in every investor's portfolio. While the allocation would depend on the investor's risk appetite, its presence (powered by the ability to impart stability to the portfolio) should be treated as vital. Furthermore, the gamut of debt offerings is huge - from conventional fixed deposits, small savings schemes to fixed maturity plans, and more. The key lies in selecting avenues that are right for you.

This guide will acquaint you with various debt offerings; also aspects like taxation, among others have been dealt with in detail.

We are certain that this guide will prove handy in helping you build a debt portfolio and in the process, aid you in asset allocation as well.

Happy investing!

Team Personal*fn*
19th June, 2007

Contents

How much debt you should own

Most investors will wonder why we are bringing up debt in the middle of all this excitement about equities. After all why would anyone want to invest his money in a staid fixed deposit (FD) when he can 'double his money in equities in no time'. Well, in our view, it is not possible to 'double your money in equities in no time' (we will leave the rationale for the same for another note). Over here, we are more keen on showing the staid FD in a new light.

Fixed income (of which FDs are a subset) is an asset class just like equities, real estate and gold, to name a few. And just like these asset classes, fixed income has as much reason to be a part of your portfolio. Of course that is not to say that all asset classes perform the same role in your portfolio, because if that were true you would not need all of them, having just one would prove adequate.

The reason you need fixed income in your portfolio is largely for capital preservation with regular income as a secondary need. Fixed income in a portfolio serves as a perfect foil for equities, which can add disproportionately to your wealth over the long-term, but can just as quickly erode wealth over the short-term. So by combining both in a portfolio, you have an asset (in equities) that can grow wealth significantly over the long-term and an asset (in fixed income) that can insulate your portfolio from short-term volatility in stock markets.

As we mentioned earlier, fixed income does not just preserve capital, it can also provide income by way of interest (in an FD or bond) or dividend (like in a debt fund, although this is not assured). So fixed income can serve a dual role in the portfolio.

What we have mentioned about fixed income can elicit two kinds of reactions from investors. There will be one group that will look at with disinterest because they are not looking for capital preservation as much as capital growth. However, the second group will look at it with some interest because capital preservation and regular income are its key investment objectives.

The first group would typically include relatively young investors who have time on their side and can use that opportunity to accumulate wealth over the long-term through the equity route. Since there are no constraints on time, they can stomach short-term stock market volatility in their quest for long-term growth. So capital appreciation is the main objective of the young investor, which is why stocks must occupy a larger share of the portfolio and fixed income must account for a much smaller allocation.

On the flipside, the second group of investors that has lower appetite for equity investments would include older investors with less time on their hands (or even, at times, young investors with lower risk appetite). Given the

constraints for time, they cannot opt for equities as a viable long-term option to accumulate wealth. So their equity allocation would be a lot lower and fixed income on the other hand with the ability to preserve capital and provide regular income would occupy a larger chunk of the portfolio.

While this may sound all very intriguing, it's actually a basic tenet of financial planning commonly referred to as diversification. By diversifying your monies across assets, you can ensure that you are not over-exposed to any single asset and are well-placed to grow your money in line with your risk appetite and investment objectives.

To give readers an idea about how fixed income can add value to an investor's portfolio let us consider two individuals - Kumar, a 30-Yr male who is married, no children. His father - Vivek is a 60-Yr old with 2 children (Kumar being one of them), both of whom are well settled, financially. According to Personal*fn*'s Asset Allocation Review, this is how the asset allocations of the father-son duo should appear:

Three points are unmistakable in the asset allocation of Kumar and Vivek.

Getting a fix on fixed income

	Kumar (Son)	Vivek (Father)
Fixed Income	10%	20%
Equities	30%	20%
Property	50%	50%
Gold	5%	5%
Cash	5%	5%

1. The fixed income allocations for the father-son are inverse, low for Kumar, high for Vivek. As we explained earlier, this is a reflection of their varying risk appetites and investment objectives. Kumar is not aiming for capital preservation as much as capital appreciation, so his fixed income allocation is lower. On the other hand, his father is looking at capital preservation, which explains the higher fixed income allocation.

2. This point is interlinked with the previous one. Lower fixed income allocation for Kumar is explained by a desire to take higher risk, i.e. invest more in equities. His father on the other hand, does not want to take too many risks in the twilight of his investing years, so he has lower equity investments.

3. The other three asset classes (property, gold and cash) have similar allocations for both Kumar and Vivek. Our view is that cash and gold must be held mainly for diversification and not for a return; on the same lines your investment in property must be for mainly residential purpose and not to clock a return. We have dealt with real estate allocation in detail in the May 2007 issue of the Money Simplified (Real Estate & You).

While we have drawn up the asset allocation plans only for two individuals, the guideline holds true for investors across other age groups. Older investors, who tend to have lower risk appetites, would like to preserve capital and must therefore have a higher fixed income allocation. Younger investors, who tend to have higher risk appetites, would like to accumulate wealth so fixed income is not as important as equities.

Of course, drawing up an asset allocation plan is not really that simple. That is where an experienced and competent financial planner comes into the picture. At Personal*fn*, we always urge investors to hire the services of a professional financial planner who can help them devise a well-balanced asset allocation plan with a defined allocation for fixed income across various life stages.

IN A NUTSHELL

- Fixed income is for capital preservation and regular income.
- Equities are ideal for accumulating wealth over the long-term.
- Older investors must go for higher fixed income, younger investors for equities.
- Getting professional help for your asset allocation plan is critical.

Debt & Mutual Funds

To most investors, the heady days enjoyed by debt funds in the 2002-03 period might seem like a distant memory. That was the time when the segment enjoyed a purple patch, powered by a soft interest rate regime. Since then interest rates have witnessed a cyclical upturn (they are on the rise even at present). Expectedly, the long-term debt funds took a hit and fell out of favour with investors. While it will always be difficult to predict in which direction interest rates will move going forward, there is a possibility that interest rates could stay put at higher levels.

Meanwhile, the debt funds segment is making a comeback of sorts. Thanks to innovation, the segment has gone beyond its conventional 'long-term debt fund' products and widened its bouquet of offerings.

In this article, we discuss some variants from the debt funds segment that investors can consider adding to their portfolios in the present scenario.

1. Fixed Maturity Plans (FMPs)

Broadly speaking, FMPs can be termed as the fixed deposit (FD) equivalents from the mutual funds segment. Like FDs, FMPs also have a predetermined investment horizon. Also, the returns they will generate are 'largely' known in advance. The key word here is - largely. In an FD, the investor knows unambiguously the returns that his investments will generate. Conversely, in an FMP, he only has a broad estimate; actually, the FMP could deliver a higher/ lower return depending on market conditions.

The fund manager targets a given yield (return) and gets invested in those targeted debt instruments. He stays invested in the same till maturity, thereby eliminating the interest rate risk. This is how FMPs have a known investment horizon and a predictable yield as well.

In another FMP variant a minor portion (10%-15%) of the assets is invested in equities; the balance being held in debt instruments. The portfolio is structured in such a manner, that the portion invested in debt adds up to the original capital on maturity; the equity portion is utilised for clocking growth.

FMPs score over FDs on the taxation front. They deliver better tax-adjusted returns for investors in the higher tax brackets.

2. Capital Protection Oriented Schemes (CPOSs)

CPOSs are similar to FMPs in terms of their portfolio structure. Like FMPs, CPOSs also invest a significant portion (80%-85%) of their portfolio in debt instruments; the balance is invested in equities. The portion invested in debt amounts to the original capital on maturity. In other words, if out of Rs 100, Rs 80 were invested in debt, the same would amount to Rs 100 on maturity. The balance Rs 20 (Rs 100 less Rs 80) is invested to clock growth.

A fundamental difference between FMPs and CPOSs is the intent. In an FMP, the underlying intent is to clock growth; on the other hand, in a CPOS, the primary objective is capital protection. Clocking returns is given secondary importance. Also, asset management companies (AMCs) are required to get their proposed CPOS portfolios rated by specified credit rating agencies. FMPs are under no obligation to have their portfolios rated. It should understood that there is no explicit guarantee in terms of the capital protection by the AMC. The portfolio is required to be structured in a manner to provide the same.

A CPOS will typically appeal to a risk-averse investor, who wishes to invest in a market-linked instrument, without exposing the capital to any risk.

3. Short-term floaters and liquid funds
Short-term floaters and liquid funds can be utilised for parking surplus funds for shorter time frames. The typical investment tenure would vary between say, 15 days to a month. Floating rate instruments have their coupon rates reset in line with that of a benchmark rate (like Mumbai Inter Bank Offered Rate - MIBOR, the lending rate among banks in Mumbai)) at fixed time intervals. Hence in a rising interest rate scenario, such instruments are equipped to deliver higher returns.

Liquid funds maintain low maturity profiles and provide opportunities for gainfully parking surplus funds over a few days. Investors who have an investment horizon of more than 15 days should go in for "liquid plus" funds. These funds taken on slightly higher risk as compared to conventional liquid funds and compensate investors by offering commensurately higher returns. The attractiveness of liquid plus has also been enhanced by the fact that they don't attract the higher tax liability (dividend distribution tax) vis-à-vis conventional liquid funds.

4. Monthly Income Plans (MIPs)
The name MIPs can be misleading; often, investors are led to believe that their investments will deliver returns on a monthly basis. In other words, investments are expected to deliver assured returns. Nothing could be farther from the truth. MIPs are market-linked investment avenues. Albeit the underlying intention is to deliver monthly returns, there are no assured returns.

Generally, MIPs invest between 5%-25% of their corpus in equities; the balance (75%-95%) is held in debt instruments. By investing across asset classes i.e. equity and debt, MIPs offer investors the benefits of diversification. MIPs have been dealt with in detail in the article "What MIPs offer".

Another category, which can be expected to deliver going forward, is long-term debt funds. At present, we are

in a scenario, wherein interest rates are on the rise. While it would be difficult to predict when interest rates will peak, our view is that interest rates could still remain at higher levels. Such a setting would be apt for long-term debt funds. We have already seen traces of what the future holds, in the performance of long-term debt funds over the last 12 months.

Identifying the right categories is only one aspect of the investment process.

The next and perhaps more vital part, involves selecting the right funds and getting invested. Investors need to select investment avenues that are right for them and invest an appropriate portion of their investible surplus therein. This is where an investment advisor can play a vital role. Our advice - engage the services of a competent investment advisor and build a debt portfolio that is geared to meet your investment objectives.

- **Taxation of Dividends earned on Debt Funds**
- **Taxation of Capital Gains earned on Debt Funds**

IN A NUTSHELL

- It's been a rough ride for debt fund investors over the last few years.
- Innovative product launches by AMCs have offered investors attractive avenues.
- FMPs offer an investment proposition comparable to fixed deposits.
- CPOSs will appeal to risk-averse investors.
- Liquid plus funds can be utilised for gainfully parking surpluses.
- MIPs offer investors the opportunity to invest across asset classes.

Fixed Deposits vs FMPs

For a long time it was a relatively simple task for the risk-averse investor when it came to investing his money. There was the good old fixed deposit (FD) in the neighbourhood bank. There wasn't much beyond that until mutual funds came along with their innovation and market-linked investments.

In the good old days it was relatively easy with FDs; you invested your money for a pre-determined period at a pre-determined rate. If you were careful to select FDs with a high credit rating rating (AAA, for instance) you would get your money back without too many worries. And of course, back then you also got a tax benefit (under the now-discarded Section 80L) on your FDs, so the post-tax FD return was considerably higher.

FDs sufficed the risk-averse investor's investment objective of capital preservation and regular income for a long time. Then mutual funds arrived and turned the scenario on its head with their innovative, market-linked products.

Among the many market-linked instruments that mutual funds have on offer, FMPs (fixed maturity plans) have the most in common with FDs. Similar to FDs, FMPs are launched by mutual funds with a predetermined tenure (like 3 months, 6 months, 366 days). In terms of a return, FMPs indicate a yield (which can be loosely interpreted as a return in FDs) that investors can expect. Unlike FDs where the return is cast in stone so to speak, the indicative yields in FMPs could change slightly (this is usually in the 0.20%-0. 30% or 20-30 basis points range).

For some time now, FMPs have been offering attractive returns on account of rising bond yields. Put simply, rising interest rates have pushed up bond yields, which has a direct (and positive impact) on a market-linked investment like an FMP. Of course, that is not to say that an assured return, non-market-linked investment like an FD does not react to market realities. Banks have also raised interest rate on FDs. From the investor's perspective, he has FDs that offer high returns on one hand, and FMPs with equally attractive yields on the other.

FMPs vs FDs: The winner is...

	Pre-Tax Rate	Post Tax Rate			
		10.30%	*20.60%*	*30.90%*	*33.99%*
Fixed Deposit	9.00%	8.07%	7.15%	6.22%	5.94%
FMP	9.15%	8.11%	8.11%	8.11%	8.11%

The numbers in italics are the income tax rates for various slabs
The 33.99% slab is applicable for investors with income greater than Rs 1 m per year.
We have calculated long-term capital gain on FMPs @10%, post-surcharge @11.33%
FD tenure is 1-Yr, FMP tenure is 367 days.

As we shall discuss in this note, while comparing FDs with FMPs you must consider one more aspect to get a more accurate picture about which is the better option. In our view, whenever investors evaluate investment options they must consider the post-tax returns to find out which is the most rewarding option. They must adopt the same approach while comparing FDs with FMPs.

The interest rate on a 1-Yr FD is 9.00%; the yield on a 367-day FMP is 9.15%. So FMPs have a 0.15% headstart over FDs at the time of investing. It is evident from the comparative analysis that the post-tax return on an FMP is even more attractive, especially for investors in the higher tax brackets.

FMPs have been known to give even higher returns; this is something we have already seen only a few months back when FMPs returned in excess of 10%.

Having said that, we urge investors to exercise caution while evaluating FMPs. Some fund houses have been known to invest in lower-rated paper for that higher yield on their FMPs. Put simply, this means that they are taking on higher risk to get a higher return. Needless to say, this can prove detrimental to the investor's interests in the event of a credit default.

IN A NUTSHELL

- The interest rate on a FD is pre-determined and remains fixed.
- Always evaluate the returns on an investment on a post-tax basis.
- Although the yield on an FMP is declared, it can change depending on bond markets.
- FMPs are particularly lucrative for investors in the higher tax brackets.
- Liquid plus funds can be utilised for gainfully parking surpluses.
- While evaluating FMPs ensure that the portfolios has highest rated (AAA) investments.

Small saving schemes: The golden oldies

For many generations of investors, small saving schemes were 'bread and butter' investments. In fact, it would be fair to say that along with fixed deposits, small savings schemes were synonymous with investing. So what made small savings schemes (also referred to as post-office schemes) so popular? Apart from lack of alternatives, two factors significantly contributed to this phenomenon - attractive returns and high safety levels (both in terms of capital invested and returns).

Albeit, the 'attractive returns' part might have taken a hit over the years, the 'high safety' aspect continues to be a major driving force. Small savings schemes have a sovereign guarantee (i.e. government-backed) and therefore offer the highest degree of safety to investors. This in turn will appeal to investors like senior citizens and retirees. Conversely, even investors with an appetite for high risk investment avenues can invest that portion of their portfolios that is 'sacrosanct', in small savings schemes.

In this article, we profile some of the offerings from the small savings segment and highlight their unique characteristics.

1. Public Provident Fund (PPF)
The PPF scheme runs over a 15-Yr period and is ideal for meeting long-term needs like planning for retirement and building a corpus for future needs. Investments in the scheme are eligible for deduction from gross total income under Section 80C of the Income Tax Act. The minimum investment amount for the scheme is Rs 500 pa, while the maximum amount has been pegged at Rs 70,000 pa. Contributions in excess of Rs 70,000 are returned without any interest. Investors are required to make contributions to their PPF account on an ongoing basis (Rs 500 pa) to keep the account 'active'.

What separates PPF from other small saving schemes is that the returns though assured are not fixed. At present, investments in the scheme yield a return of 8% pa; however, the interest rate is subject to revision on an annual basis. Hence in an inflationary scenario, returns would typically turn attractive and vice-versa. PPF offers tax-free returns i.e. the interest income is exempt under Section 10. The scheme fares poorly on the liquidity front. Premature withdrawals are only permitted at the end of the sixth year; also the amount that can be withdrawn is a factor of the contributions made in the earlier years.

2. National Savings Certificate (NSC)
Investments in NSC fetch a return of 8% pa, compounded on a half-yearly basis. However, unlike PPF where investments are made on a recurring basis, investments in NSC are on a one-time basis. Hence, the rate of return is locked-in for the entire investment tenure i.e. 6 years. NSC can be utilised for deploying one-time surpluses like bonuses and

gifts.

The minimum investment amount is Rs 100; while there is no upper limit for investing in the NSC. Investments upto Rs 100,000 pa are eligible for deduction from gross total income under Section 80C of the Income Tax Act. Similarly, interest accrued is eligible for deduction under Section 80C as well. NSC fares poorly on the liquidity front. Premature withdrawals are permitted only under specific circumstances such as death of the holder(s), forfeiture by the pledgee or under court's order. Finally, the interest from NSC is fully taxable.

3. Post Office Monthly Income Scheme (POMIS)
As the name suggests, POMIS offers monthly income to investors. Unlike investments in monthly income plans (MIPs) from the mutual funds segment, returns from POMIS are assured. This scheme will appeal to investors who need regular income with safety of capital. The investor is required to deposit a lumpsum amount and returns are generated at 8.00% pa, on a monthly basis. On maturity, the original amount invested is returned to the investor. Interest from investments in POMIS is fully taxable.

POMIS runs over a 6-Yr time frame. The minimum investment amount is Rs 1,000; the maximum investment amounts are Rs 300,000 and Rs 600,000 for single and joint accounts respectively. Investments in POMIS can be prematurely withdrawn after one year from the date of investment. However, the same would entail a loss in the principal amount; the amount deducted will depend on the investment tenure.

4. Post Office Time Deposit (POTD)
Fixed deposits would rank as debt instruments in their most conventional form. POTDs are fixed deposit offerings from the small savings segment. Investors can choose between time frames of 1 year, 2 years, 3 years and 5 years offering returns of 6.25% pa, 6.50% pa, 7.25% pa and 7.50% pa while investing in POTDs. While the interest is compounded on a quarterly basis, it is paid annually. Interest from investments in POTD is fully taxable.

The minimum investment amount for POTDs is Rs 200, while there is no upper limit. Premature withdrawals are permitted after a period of 6 months from the date of investment; however, investors have to bear loss of interest. The loss incurred will depend on the investment tenure.

5. Senior Citizens Savings Scheme (SCSS)
The SCSS is dedicated for citizens who are above 60 years of age; however provisions have been put in place to permit individuals who have crossed 55 years of age to participate in the scheme, subject to fulfillment of certain conditions. Investments in the scheme fetch a return of 9.00% pa, making it the most attractive offering in the small savings segment. Interest payments are made on 31st March, 30th June, 30th

September and 31st December each year. The interest is fully taxable and subject to tax deduction at source (TDS) as well.

The minimum and maximum investment amounts are Rs 1,000 and Rs 1,500,000 respectively. The investment can be held either individually or jointly with one's spouse. Premature withdrawals are permitted after one year from the date of investment. Investors who prematurely liquidate their investments in SCSS have to bear a loss in the principal amount; the amount deducted is a factor of the investment tenure.

Clearly, the small savings segment has a wide variety of investment options to offer. Investors on their part need to make informed investment decisions both in terms of selecting the investment avenue and deciding the portion of their portfolio that should be invested therein.

Small savings schemes at a glance

Scheme	Interest Rate (pa)	Term	Min-Max Investment	Premature Withdrawal	Tax Benefit
PPF	8.00%	15 yrs	Rs 500 - Rs 70,000	Yes	U/S 80C & 10 of IT Act
NSC	8.00%, compounded half yearly	6 years	Rs 100 - no upper limit	No	U/S 80C of IT Act
POMIS	8.00%, paid monthly	6 years	Min.-Rs 1,000; Max.-Single acct. Rs 300,000 - Joint acct. Rs 600,000	Yes	Nil
POTD	1-Yr-6.25% 2-Yr-6.50% 3-Yr-7.25% 5-Yr-7.50% comp qtrly.paid yearly	1 - 5 years	Rs 200 - no upper limit	Yes	Nil
SCSS	9.00%, paid quarterly	5 years	Rs 1,000 - Rs 1,500,000	Yes	Nil

IN A NUTSHELL

- High safety levels continue to be a draw for small savings schemes.
- PPF and NSC offer tax benefits under Section 80C.
- POMIS and POTD will appeal to investors who seek liquidity.
- SCSS is a scheme dedicated for senior citizens and retirees.

What MIPs offer

Monthly Income Plans (MIPs) shot into prominence in the 2003-04 period. The end of the soft interest rate regime meant that conventional long-term debt funds were no longer attractive investment avenues; conversely, equity markets had begun to turnaround by then. MIPs were perceived as a perfect foil for the scenario at that point in time. They were positioned as investment avenues that offered the best of both worlds i.e. the stability of debt and the power of equities.

What are MIPs

MIPs are predominantly debt investments with a mandate to invest a smaller (between 5% to 25%) portion of their corpus in equities. The aggressive offerings have higher equity allocations. Despite being invested in a single investment avenue, investors enjoy the benefits of diversification by being invested across asset classes. MIPs work with the sole objective of outperforming pure debt investments with the help of equity. Typically, MIPs can be ideal investment avenues for investors (having low to medium risk appetite), who are willing to go beyond the spectrum of small savings schemes and fixed income instruments with a view to clocking higher growth by taking on higher risk.

Investors should not confuse MIPs with conventional debt funds. Both differ from each other in terms of investment objective as well as asset allocation. MIPs aim at providing regular income to investors (although this income is not guaranteed), while income funds have the primary objective of capital preservation with capital appreciation as the secondary objective. Also, in order to meet their investment objective, MIPs invest a small portion of their assets in equities. On the other hand, income funds invest only in debt securities (like corporate bonds, government securities, treasury bills, and cash/call).

The misnomer

As the name suggests, MIPs are designed to deliver regular returns (in the form of an income or dividend) to investors. However, it should be well understood that the same is an intent and not an assurance. In other words, MIPs don't offer assured returns. Dividends in MIPs, as with other mutual funds, are declared only if there is adequate surplus for the same. Often the confusion stems from the fact that MIPs are confused with Post Office Monthly Income Scheme (POMIS) from the small savings segment, which offers assured returns.

MIPs come with monthly, quarterly, half-yearly and annual options. The periodicity of returns depends on the option chosen by the investor. An investor who selects the growth option will not be entitled to receive any dividends; his return will be in the form of capital appreciation.

Powered by the flexibility to invest across asset classes (debt and equities), well-managed MIPs can offer immense value to investors' portfolios. However, there are some important aspects, which investors must consider before getting invested.

1. Higher equity allocations don't make MIPs better

A higher equity component doesn't necessarily make an MIP a better investment option. Although, the mandate to invest in equities is one of the defining features of the segment, investors must select a fund, which best suits their portfolio and risk appetite. A higher equity allocation may generate higher returns, but it can also make the fund more prone to stock market volatility, thus increasing its risk profile. Furthermore, investors must check if the fund abides by its stated mandate in terms of equity allocations, at all times.

2. Examine the fund's debt portfolio

Since MIPs are predominantly debt investments, investors should examine its debt portfolio thoroughly before making an investment decision. Broadly speaking, the performance of debt instruments would largely depend on the prevailing interest rate scenario. Therefore, when interest rates are rising, the debt portfolio should ideally be dominated by floating rate instruments and visa-versa. Conversely, when interest rates have peaked, one would expect the portfolio to have long-term fixed rate instruments.

Besides this, the other factor that needs to be considered is the debt portfolio's credit rating. A portfolio dominated by instruments with AAA/similar rating (which indicate the highest degree of safety) signifies that the fund manager has no intention of taking on any credit risk. On the contrary, a lower rated portfolio would point towards the intent of clocking higher returns by taking on commensurate credit risk.

3. Select the quarterly dividend option

Conventionally, the monthly dividend option has been the preferred choice for most investors. And perhaps rightly so, given the proposition offered by MIPs. However, we recommend that investors should opt for the quarterly dividend option. The quarterly dividend option provides the fund manager with more breathing space. This in turn increases probability of investors getting regular dividends vis-à-vis the monthly option.

IN A NUTSHELL

- MIPs can invest across equities and debt.
- Dividends in MIPs are not assured.
- Invest in MIPs according to your risk profile.
- Ensure the MIP adheres to its equity mandate.
- Keep an eye on the debt portfolio of your MIP.
- If you are looking for dividends, go for the quarterly option.

Interview with Dhawal Dalal

Dhawal Dalal is Senior VP and Head of Fixed Income at DSP Merrill Lynch Fund Managers. He joined Merrill Lynch Investment Managers in 1996 after his MBA from the University of Dallas. He worked with the Merrill Lynch Private Client Group for approximately a year. He then joined the money market desk of Merrill Lynch Investment Managers before returning to India to join DSP Merrill Lynch Fund Managers.

Please can you put in perspective the investment environment in the debt markets over the last 4 - 5 years?

Dhawal: Investing in to fixed income markets has been both rewarding as well as challenging over last five years. Broadly speaking, interest rates have exhibited strong linkage with the economic growth of the country. For example, in 2002 and 2003 softer economic growth had resulted in a secular decline in interest rates across the fixed income asset classes, which had been quite rewarding for both the fixed income market participants as well as investors. However, stronger and faster economic growth in last three years had pushed interest rates up significantly as compared to 2002 and 2003. This interest rate environment had been quite challenging for the market participants in terms of developing new products and asset classes to meet investors' demand for returns.

Going forward, where do you see interest rates, both short term and long term?

Dhawal: Judging by the recent economic data, we believe that we are still in the robust economic growth cycle. Both the government and the Reserve Bank of India are confident of achieving above 9% economic growth in next three years.

In the backdrop of this economic growth forecast, we expect interest rates to trend up in short-term. Long-term trend in interest rates may depend upon many global and local economic factors which are difficult to forecast accurately.

Is inflation a worry for you? Please also share with us the metric you look at while tracking inflation. Why?

Dhawal: Generally speaking, inflation is a cause of concern to every citizen. Whenever, there is an uncertainty on the price front, it tends to destabilize the delicate balance between demand and supply. In India, headline inflation has been quite volatile over last five years due to various reasons such as poor monsoon, poor agriculture output, higher oil prices etc.

We follow the common sense approach to inflation forecast. Since there are three main components to our inflation basket, we attempt to keep a close eye on each of these baskets and their subcomponents for further clues on their trend. We also observe international markets for price trend on commodities such as crude oil, steel, aluminum and copper.

Having said that, headline inflation can distort the real story due to "base-effect".

FMPs have emerged as popular investment avenues for investors in the recent past. Why are FMPs able to offer a better yield as compared to say a liquid fund or a fixed deposit?

Dhawal: Fixed Maturity Plans (FMPs) have become quite popular with investors in the recent time due to their superior return potential as compared to plain vanilla liquid funds. These FMPs are closed-ended income funds in nature and therefore are suitable for investors with fixed investment horizon. These FMPs can offer better returns as they seek to match investors' investment horizon with suitable fixed income assets with suitable maturity profile and therefore, seek to remove interest rate risk from the portfolio.

Taxation also plays an important role in the decision making process. Since fixed deposits are taxed at marginal tax rate while liquid funds have a dividend distribution tax of around 28% for retail investors. On the other hand, dividend distribution tax for FMP is around 14.05%. This lower level of tax also plays an important role in deciding asset allocation in favor of FMP.

Please can you explain the new regulations, which SEBI has put in place to limit the amount of monies flowing from mutual funds in fixed deposits. How will this impact the various funds?

Dhawal: SEBI, through its recent circular has sought to clarify their stand on issue pertaining exposure to fixed deposits. Some of the important things are as follows:

1. Maximum tenor of a fixed deposit has been fixed at 91 days
2. Maximum exposure of fixed deposit in any particular fund is 15%
3. Maximum exposure of fixed deposit of a particular bank is 10%

We believe that SEBI's circular on fixed deposit has now created a level-playing field among mutual funds and therefore, will be beneficial to the progress of fixed income funds in future.

What is your view on MIPs? Do you think MIPs should find a place in the conservative investor's portfolio?

Dhawal: Monthly Income Plans (MIPs) are suitable for investors with conservative risk profile as they provide investors' with a little-bit of exposure to the equities with a view to provide investors with a little-bit of extra return with marginally higher risk profile as compared to g-sec funds.

One way to increase returns on a debt portfolio is by compromising on its quality; the higher the risk (poor quality debt), the higher the return (higher interest rate). In present times as AMCs compete to grow AUM, the short term strategy at some AMCs is to compromise on quality to deliver returns. Is this menace for real in the industry? How should investors spot such instances?

Dhawal: We believe investors must educate themselves with the investment objective and asset allocation of the fund before investing. They should also look at the current as well as past portfolios of the fund to find out the investment style of the fund manager and his risk mitigation approach.

We believe every credit risk in the portfolio should be examined thoroughly before buying. Low credit rating of a particular fixed income asset may provide fixed income investors with some opportunities at times by offering higher returns while exposing investors with the risk of credit downgrade and risk of spread-widening.

What is your advice for an investor in the debt segment from a short-term and long-term perspective?

Dhawal: We believe there is a higher probability of one more rate hike by the Reserve Bank of India in near-term. Keeping that in mind, we believe fixed income investors should invest in the fixed income funds with low duration as of now and should gradually increase their allocation to higher duration.

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