Business Standard

Smart moves in a falling interest rate regime

Shift to cheaper loans and look at dynamic funds

Sanjay Kumar Singh **October 12, 2016** Last Updated at 21:50 IST

In their first policy review, the new Reserve Bank of India (RBI) governor and the Monetary Policy Committee (MPC) debuted with a repo rate cut of 25 basis points (bps), bringing it down to 6.25 per cent. While fixed-income investors stand to lose from falling interest rates, borrowers stand to gain. Both need to realign their strategies to make the most of this low rate environment.

One more rate cut, perhaps

Experts say rates may soften a little more. "RBI is comfortable with an inflation range of four to six per cent. India is experiencing significant disinflation, with further disinflation possible in pulses. The next few inflation readings may print significantly lower than the RBI's suggested inflation trajectory. Hence, there is a possibility of another rate cut of 25 basis points (bps) either in the December policy or by March," says Suyash Choudhary, head of fixed income, IDFC Mutual Fund. The caveat: If global volatility continues to rise, the RBI may have to defer its rate cut.

The majority view is that we may now be close to the end of the rate cut cycle. Only a few believe that interest rates are headed structurally downward, allowing for further rate cuts of 100-125 bps over the next 18 months.

RETURNS SET TO FALL

With a good part of the fall in interest rates over, past returns may not get repeated soon in longer-duration funds. Shift to shorter-duration funds

	Category average return (%)		
	1-year	2-year	3-year
Corporate credit	10.2	10.36	10.16
Intermediate bond	10.27	11.23	10.13
Short-term bond	9.62	9.35	9.25
Ultra-short bond	8.73	8.64	8.8
Liquid	7.67	8.04	8.41

Data as on October 12 Source: Morningstar.in

Fixed deposits

Fixed-income investors should invest in products that match their risk profile. "When rates begin to fall, investors typically begin to invest in products that are too risky for their profile. They should only invest in products that match their risk profile, even if it means settling for lower returns in the short term," says Choudhary. It may also be prudent to lock into current yields. "Investors compare current rates with those prevailing in the past and are unwilling to lock into those prevailing now. But, even these opportunities could vanish over the next six to nine months," says Manoj Nagpal, chief executive officer (CEO), Outlook Asia Capital.

Investors in the highest tax bracket looking to lock into current rates for the long term may buy tax-free bonds from the secondary market. These offer a yield-to-maturity of 6.25-6.35 per cent. Those in the lower tax brackets may bet on highly-rated corporate deposits.

Among small-savings schemes, segment-specific products are still offering good returns. Both the Senior Citizens Savings Scheme (SCSS) and the Sukanya Samriddhi Yojana, with a return of 8.5 per cent, are good products for senior citizens and the girl child, respectively. The Public Provident Fund's tax-free returns are also still sound at eight per cent.

Debt funds

A holding period of more than three years in debt funds works well for investors in the higher tax brackets due to the indexation benefit. Fixed maturity plans (FMPs) allow investors to lock into current yields. "You buy an unknown portfolio when investing in an FMP. In chasing higher yields, don't compromise on credit quality," warns Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors. The same applies to investing in short- and medium-term bond funds (modified duration of two-five years). Since yields are down, opt for funds with a lower expense ratio.

Nagpal suggests investing in dynamic bond funds since he believes rates may fall by another 100-125 bps over the next 18 months. Choudhary suggests these funds because they are actively managed and tend to do well across interest rate cycles, not just when rates are falling. Dhawan, on the other hand, warns that one needs to evaluate if the higher expense ratios of dynamic bond funds (relative to other debt funds) can be justified by their potential returns, now that interest rates are down.

According to Choudhary, investors could put a part of their portfolio in credit funds, provided they are comfortable with the papers in the portfolio. He also suggests arbitrage and arbitrage-plus funds (those that have a mix of arbitrage and fixed-income strategies) if the investor's tenure is one-two years. Their post-tax returns, he says, turns out to be good in a depressed-rate scenario.

Shift to lower rates

Interest rates on home loans have come down by around 50 bps since the beginning of the year, with the best rate available declining to 9.25 per cent. If banks decide to pass on a greater portion of the fall in interest rates to customers, home loan rates could fall further.

While new borrowers get the benefit of the latest rates, older borrowers could still be stuck at higher levels, especially if they had borrowed under a different regime, say, base-rate linked, instead of MCLR-linked. One option for such borrowers is to do a balance transfer. Says Parth Pande, co-founder and CEO, Finance Buddha: "According to RBI norms, banks are not allowed to levy prepayment charges on home loans. However, there will

be processing costs at the new bank. In some cases, there could be some pre-closure charges at the older bank that override the generic norms. Do a calculation of the money you stand to save and the costs involved before going for a switch." If the value of your property has appreciated, you can also avail of additional funding on your home loan.

When making the switch, shift to a better home loan product. Today home saver or credit loans have become available. Home loan customers are made to open a current account. "For any money that is parked in the current account, the customer is not charged interest on the home loan for that amount. This can result in significant saving on interest cost," says Pande.