

Inflation indexed bonds: Down but not out

Written by [Sandeep Singh](#) | Updated: November 27, 2015 1:21 am



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In June 2013 when the Reserve Bank of India auctioned its first tranche of WPI-linked Inflation Indexed Bonds (IIBs), it received strong market response as it offered a 1.44 per cent annual return over and above the headline inflation (WPI), which then stood at 4.9 per cent.

Subsequently, as experts suggested that bonds should be linked to the consumer price index (CPI), which is a better indicator of inflation, six months later, in December 2013, RBI launched Inflation Indexed National Saving Securities-Cumulative, 2013, (IINSS-C) for retail investors. The bond was CPI-linked and offered inflation plus a coupon rate of 1.5 per cent per annum.

In December, the CPI stood at a high of 9.87 per cent. As inflation levels stood high at the time of their introduction in 2013, advisers stamped these as instruments that need to be a part of any investor's portfolio as it offered protection against inflation along with an additional interest income over and above the inflation rate.

However, 30 months down the line, with WPI inflation in the negative and CPI inflation, too, having softened to around 5 per cent, the bonds are losing their charm and have generated significantly lower returns than traditional debt instruments of banks and post offices.

While three mutual funds — HDFC, DWS and SBI — launched schemes that invested in the WPI-linked inflation indexed bonds, over the last one year, the best performing scheme, which is of SBI, has generated a return of 3.12 per cent whereas the scheme of DWS has generated a return of just 2.39 per cent. This has been a result of WPI inflation treading in the negative territory. However, RBI is offering CPI-linked IINSS-C to retail investors and since CPI is hovering at around 5 per cent, there is a better option available with them. With the possibility of banks reducing their offering on deposits and inflation always threatening to come back, the instrument is far from losing its relevance.

CASE STUDY

INFLATION INDEXED NATIONAL SAVING SECURITIES – CUMULATIVE

₹5,000

Face Value of security

₹5,00,000

Maximum investment per applicant per annum

RATE OF INTEREST: real interest rate (1.5% fixed) + inflation rate.

INFLATION: Final combined CPI used as reference CPI with a lag of three months

COMPOUNDING: Half-yearly

TENOR: 10 years

TAX TREATMENT: Interest and principal repayment would be taxed at the marginal tax rate.

ELIGIBILITY: Individuals, Hindu Undivided Family, charitable institutions and universities

Softening inflation and IIB

While the RBI has set an inflation target of 6 per cent for January 2016, RBI Governor Raghuram Rajan has maintained that the focus would be to bring inflation to around 5 per cent by the end of 2016-17. Even economists say that in the long term inflation would remain within the RBI's target. "While there is always a risk that inflation may spike as commodity and oil prices are currently low, I don't see it to be above RBI's target on a sustained basis," said Abheek Barua, chief economist with HDFC Bank.

There are others, too, who hold the same view. DK Joshi, chief economist with Crisil said, "I don't think that inflation will exceed 6 per cent in the long-term. I think it should be around 5 per cent for the next five years."

This means that if the average inflation remains at 5 per cent in the long run, investors would at best get a return of 6.5 per cent on their investments in inflation indexed bonds. But experts say that the idea of inflation-indexed bonds is not to get higher and higher yields but to act as a hedge and to safeguard the investor against macroeconomic risks.

"From a portfolio strategy point of view it makes sense for investors to have a part of their investment within this category so as to diversify and protect your investments against macroeconomic risks, inflation being a principal macroeconomic risk," said Barua adding that it makes a lot of sense for banks and other domestic institutions to hold such bonds.

Should you invest?

If inflation remains between 5 and 6 per cent in the medium- to long-term, it may not seem very attractive for the retail investors as their returns would remain limited between 6.5 and 7.5 per cent (inflation plus the annual coupon of 1.5 per cent payable semi-annually). This means that investors would get a lower return than those offered by banks which are currently offering between 7.25 and 8.5 per cent on their term deposits across tenures. But experts say that the interest rates being offered by banks may not remain high. "If the inflation remains low, banks would also bring their deposit rates down. Currently banks are holding on to higher deposit rates as the small savings rates are high. But going forward, at low inflation, the interest rates offered by them will also come down," said Joshi.

So there may be a case going forward that the earnings from IINSS-C may get in line or even higher than the rates offered by banks or other small savings instruments. Financial planners say that at present it may not make sense for investors to invest in them but that does not mean that the instrument has lost its relevance.

"The retail participation has been very low in these instruments and in the current environment it may not be very relevant as banks and other traditional savings instruments are offering a higher rate of return. In fact, for the three mutual fund schemes the real rate of return has gone down significantly as WPI turned negative. I think the real rate of return has to be comparable to make it attractive for investors," said Vishal Dhawan, CFP and founder of Plan Ahead Wealth Advisors.

So, from a portfolio strategy point of view, if it made sense to invest in gold in a bid to safeguard investments against inflation, the CPI-linked IINSS-C, which offers above inflation return and allows redemption after one year from the date of issue for senior citizens and after 3 years for others, makes a strong case to act as replacement to gold investments. It may seem as unattractive at present but as interest rates offered by banks go down and inflation picks up, this instrument will become attractive. One must not forget that commodity and oil prices are significantly low and a rise in the prices may bring inflation back.

Some experts are also pointing to the fact that if the government accepts the recommendations of the 7th Pay Commission that had proposed hefty pay and pension hikes for central government employees and pensioners, it would lead to a rise in inflation as disposable incomes will go up. In such a situation, one can never rule out inflation and the bonds linked to them.