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To earn higher interest income, you have to take some measured risks

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Representative Image

Interest rates in India are on the upswing. The benchmark 10-year G-Sec bond yield is up around 81 basis points over the past year. Currently, it stands at 7.77 per cent. And, there are expectations that yields would harden further in the second half of the year because the central government's borrowing programme has been pushed back. As a result, borrowing will be higher in the second half of the year. State governments, too, are also likely to borrow heavily. Given that 2019 general elections are fast approaching, there could also be some surprise expenses from the government.

For fixed-income investors, this is undoubtedly good news, as interest rates will go up. In fact, they already are. Banks like State Bank of India, ICICI Bank, HDFC Bank and others are slowing raising deposit rates. But, instead of just looking at fixed deposits from banks or non-banking financial companies, investors could earn higher interest income from other instruments, such as non-convertible debentures, fixed maturity plans and such.

For starters, if you want to wait and lock yourself into higher rates in the future, the strategy should be to be in shorter-term deposits or funds. Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors, says: "If you decide to invest in fixed deposits, go for a tenure of six to nine months. This will allow you to move to deposits offering higher interest rates if rates continue to rise in the near future." Deepesh Raghaw, founder, PersonalFinancePlan.in, adds: "At this point in time, however, investors should stick largely to shorter-duration debt funds that are not subject to duration risk." However, if you want to invest now, there are some options.

Non-convertible debentures: SREI Equipment Finance has come up with a lucrative non-convertible debenture (NCD) issue that is offering the best interest rates in the current scenario. The coupon rates ranging from 8.5 per cent for 400 days to 9.6 per cent for 10 years. The issue is open until May 15. The interest rates are better than the recently concluded NCD issue of Muthoot Finance that offered up to 9 per cent. NCDs are unsecured bonds that cannot be converted into a company's equity. Risks are higher, and so are interest rates. Another four-five issues are expected in the coming months which could offer even better rates.

Accrual funds: Then, look to invest in accrual-oriented funds that stand to benefit from the rise in yields over the past year. An accrual-oriented fund is one that does not take long duration calls but relies on the interest income from bonds. If it is a short-term fund, its average maturity will fluctuate between 1.5 and 2.5 years, and if it is a medium-term fund, it will fluctuate between 2.5 and 5 years. Such a fund also invests more in corporate bonds of double-A and triple-A quality than in gilts.

Opt for FMPs to circumvent interest-rate volatility: If you want to lock yourself into the current yields and avoid the volatility that the debt markets might witness due to see-sawing yields, one option you might opt for is fixed-maturity plans (FMPs). FMPs are closed-end debt schemes. They invest in a variety of debt papers that they hold until maturity. As the holdings within the portfolio are not traded, FMPs don't carry any interest rate or duration risk. They only carry credit risk, that is, the papers they have invested in can face downgrades or can default.

Most mutual fund houses provide an indicative portfolio to investors. Avoid fund houses that invest in papers rated lower than AA+. FMPs investing in lower-rated papers can offer higher returns, but they carry higher risk as well. If you invest in an FMP of more than three years, you will become entitled to indexation benefit, which will bring down your tax liability significantly. Investors should, however, be aware of the absence of liquidity in FMPs. While these securities are listed on exchanges, investors might have to sell at a significant discount.

Keep an eye on your hybrid funds: If you have invested in hybrid funds, such as balanced funds or MIPs, which have a significant debt component, you should keep a close watch on the debt portion of the portfolio. "Sometimes, in a rising rate scenario, fund managers reduce the duration, but at the same time they also take on more credit risk. This is something to watch out for," says Dhawan.

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