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Choose Debentures that Suit Your Investment Goals

Prashant Mahesh advises investment in only long-maturity non-convertible debentures of highly-rated companies to minimise risk

Brokerage houses recommending or selling listed debt securities to retail investors were unheard of until recently. However, the poor show of equity markets in the past few months and investors' reluctance to invest in equity products have prompted some brokerages to start recommending listed non-convertible debentures (NCDs) to investors. For example, HDFC Securities comes up with a weekly NCD report, which recommends NCDs across different maturities to their clients. Edelweiss Securities too offers a list of NCDs on their website. "There is a new trend with investors increasingly opening broking and demat accounts in the past one year to buy non-equity products like tax-free bonds and NCDs," says Jyotheesh Kumar, Senior VP, HDFC Securities.

However, you will face a problem of plenty if you are looking to shop for NCDs in the market. To begin with, there are a large number of companies — both state-owned PSUs and NBFCs — that offer these products.

Then there are NCDs for different tenures that offer disparate rates. You might even find that there is a huge difference between rates offered for NCDs with similar maturities. For example, there is State Bank of India – N3, which gives you an interest of 9.75% per annum. It is traded at . 10,509 and will mature in March 2021, giving a yield to maturity (YTM) of 9.39%. On the other, an NCD from gold loan company Muthoot Finance –N2 gives you an interest of 12% per annum. It is quoted at . 1,095, and will mature in September 2013, giving you an YTM of 13.33%. Similarly, a tax-free bond of IRFC – N1 offers an interest of 8%. It is traded at . 1,053, and will mature in February 2022, thereby giving you an YTM of 7.76%.

Now, which one will you pick up? "Look at the post-tax returns and the rating before investing in an NCD," says Jyoteesh Kumar.

"Invest in an NCD with an objective of holding to maturity. So if your time frame is three years, invest in an NCD which matures in three years and not in 10 years," says Vishal Dhawan, founder, Plan Ahead Wealth Advisors.

LOOK AT RETURNS AFTER TAX

You have to closely look at the taxation aspect while investing in an NCD, because interest on NCDs is taxed. And if you are in the higher tax bracket, you would be taxed at 30.9%. Needless to say, it would rob your returns in a big way. For example, look at the SBI N3 bond we discussed earlier. Its YTM of 9.39% would look attractive, but your yield to maturity would be a measly 6.55% if you are in the highest tax bracket. That is why it makes sense for someone in the highest tax bracket to look at tax-free NCDs. There are several bonds from NHAI, IRFC, PFC and HUDCO that offer tax-free interest. For example, at the current market price of . 1,053, the 8% tax-free IRFC –N1 bond gives you an YTM of 7.76%.

DON'T COMPROMISE ON QUALITY

The importance of rating or quality of the company can't be overstated when it comes to debt investors. Consider Manappuram Finance – N3, which has an "AA-" rating. The NCD, which carries a coupon of 12.20% and matures in September 2013, trades at . 1,040, giving an YTM of 13.46%. As against this, L&T Finance- N2, with an "AA+" rating maturing in September 2014, gives you a yield of 10.79%.

"The difference in yield is because L&T has a higher rating and is a diversified company, while Manappuram is a single product company," says a Mumbai-based wealth manager. Retail investors would do well to

buy NCDs bonds that have a

high rating and a diversified portfolio. PSU bonds like NHAI, REC, SBI have an "AAA" rating, which indicates very high safety in terms of timely repayment of principal and interest.

GO FOR LONGER-TENURE PAPER

Buying paper of shorter tenure such as six months to two years doesn't make much sense at this point of time. For one, when the NCD matures there is the reinvestment risk. You may even end up getting a lower interest rate at that time. "It would be better if you can invest in longer-maturity NCDs as that will reduce reinvestment risk," says Deepak Panjwani, head (debt markets), GEPL Capital. "Interest rates are at their peak now and we expect them to fall in the future," says Ajay Manglunia, senior VP (fixed income), Edelweiss Capital. In case interest rates fall in the long term, you could benefit as prices of longer-tenure bonds will go up, thereby giving you capital appreciation.

HOW LIQUID IS THE BOND?

Investors should keep in mind that though NCDs are listed on stock exchanges, their traded volume is thin because of the low level of awareness. Many of these NCDs have a very small issue size and investors typically hold on to them till maturity. "Many NCDs are illiquid, and many a time if you are desperate to sell, you may end up selling at a lower price, thereby lowering your return," says Ajay Manglunia. In short, don't try to use this as a product to trade interest rate cycles. Buy it for investment purposes only if you plan to hold it till maturity.

Some NCDs You Can Buy

	Last traded price (₹)	Coupon Rate (%)	Tenor (Years)	Residual Maturity (Years)	YTM (%)
Tax-free bonds					
IRFC -N2	1,053	8.1	15	14.55	7.76
Power Finance Company	1,077	8.2	10	9.48	7.68
HUDCO	1,051	8.1	10	9.57	7.85
Taxable bonds					
SBI - N3	10,500	9.75	10	8.6	9.39
SBI - N2	10,548	9.5	15	13.24	9.19
Shriram Transport Finance - N2	1,026	11.25	5	2.08	11.86

Market price as on 11th August 2012

SOURCE: HDFC SECURITIES