EXPRESS Money
The Indian EXPRESS
www.expressmoney.in

TAX-SAVER FUNDS

COMBINE TAX SAVING WITH INVESTMENT DISCIPLINE

Have the first of the tax cuts appeared on your salary slip? Are you hunting for a tax-saving instrument? A good ELSS fund is what financial planners think you need

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WITH only three months to go before the financial year ends, the accountant at your office has probably warned you to submit evidence of the tax-saving investments you have made during the year. If you have not invested in such an instrument already, you will now probably begin hunting for one. One instrument that combines the high returns of equities with the tax advantage available under Section 80C is the equity linked saving scheme (ELSS) or the tax-saver fund.

If you are comfortable with the volatility inherent in equities, then a tax-saver fund offers several advantages. The average five-year return from this category has been an attractive 21 per cent. Compared to other tax-saving instruments, say Public Provident Fund, which has a lock-in of six years, the lock-in here is lower at three years. Then there is the tax advantage. If you belong to the highest tax bracket and you invest Rs 30,000 in an ELSS scheme, then because of the 30 per cent tax saving, you have virtually invested only about Rs 20,000. But the scheme earns you money on Rs 30,000. Hence the tax-adjusted returns work out to be very high.

Advantage close-ended funds

While most investors regard the lock-in period in ELSS schemes as an inconvenience, financial planners see it as a blessing. Says Sumeet Vaid of Financial Freedom Financial Planners: "The lack of liquidity inculcates discipline and helps investors meet their long-term goals. Left to themselves, investors would enter equities at the peak and exit at the bottom. Most investment decisions are guided by greed and fear. In a close-ended fund, these emotions are not at play. You are forced to keep investing irrespective of the state of the markets."

A recent study done in the US underscores the importance of systematic investment. The study began in 2007 and went back 20 years. It found that equity funds generated average returns of 10 per cent over that period, but the investor earned an average return of only 5 per cent from them. The reason: investors entered funds at the peak and exited them at the bottom. They did not stay invested through market cycles to enjoy the fruits of equity investment.

The close-ended nature of an ELSS scheme gives it another advantage. "Since fund managers do not have to worry about redemption pressures, they can take a longer-term view," says Vaid.

How to invest?

Ideally, equity investments should be made through a systematic investment plan (SIP). As Dhirendra Kumar, chief executive officer of fund rating agency Value Research says: "If you invest a lump sum and the market tanks, it will take you a long time to recover that loss. But if you invest systematically every month, then even a bad fund manager can't do you too much harm."

It would have been best if you had begun the SIP for your ELSS scheme at the start of the financial year. But since you have left it for the last quarter, you may as well invest now. Says Pune-based financial planner Veer Sardesai: "Since equities help you build wealth over the long term, and given the tax advantages, you may invest a lump sum amount in an ELSS fund this year. But next year you must begin an SIP." Further, he insists that you stay invested for at least five years to overcome the impact of any decline in the markets.

According to Mumbai-based financial planner Vishal Dhawan, current market valuations have already factored in expectations of earnings upgrades. Disappointments could lead to sharp corrections. Hence, he says, avoid investing a lump sum. "Invest in three parts over the three remaining months of the financial year, unless you work for a company that requires proof of investment immediately," he says.

Choosing the right tax saver

In case of a tax saver fund especially, do a lot of homework before choosing a fund, since you are going to commit money to it for a long time. Here are factors you should take into consideration:

Fund house. This is perhaps the most important factor. After the recent regulatory changes (ban on entry load), the mutual fund industry is likely to see a round of consolidation. Hence, invest your money with the larger fund houses that are likely to survive. These must be serious, long-term players in the fund management business.

Avoid fund houses that have been around for less than five years. If you are investing with a fund house that has foreign parentage, check how much capital they have invested in India (it will provide an insight into their commitment to the Indian arm). Moreover, fund management must be one of the core businesses of the parent. For instance, in the case of DSP Blackrock Mutual Fund, Blackrock is the world's largest player in asset management. Hence one can be secure in the knowledge that they will not quit the business a couple of years down the line.

Further, according to Vaid, "The core personnel in the top management team should have remained unchanged for a long time. To cite specific examples, Nilesh Shah at ICICI Prudential, Milind Barve at HDFC, and A. Balasubramanian at Birla Sun Life Mutual Fund have all been around for a long time at their respective fund houses. Similarly, at Templeton the core team has remained unchanged for the last 10 years."

According to Sardesai, "Go with a fund house that has a well-articulated investment philosophy. For instance, Franklin Templeton has a value strategy that all its funds try to follow."

Different financial planners have different favourites among fund houses. Vaid likes Birla, DSP Blackrock, HDFC, ICICI Prudential, Reliance and Templeton. Sardesai prefers Birla, HDFC, Sundaram and Templeton. Dhawan prefers Birla, Fidelity, HDFC, SBI, and Sundaram. (Thankfully, there is some overlap between what the different financial planners like. That should make your task of choosing a fund house easier.)

Fund type. Sardesai, who believes ardently in index funds, laments the absence of these funds in the ELSS category. (The Franklin India Index Tax Fund is no longer open for subscription.) Forced to choose from actively-managed funds, he prefers diversified funds with a large-cap orientation. Such funds, he says, rely more on a research team rather than on just the fund manager. "A number of these diversified large-cap oriented funds have an R-square of 0.95-0.96. This indicates that 95-96 per cent of their returns come from the index. The fund manager contributes only 4-5 per cent of the returns. A fund manager's departure will have less of a negative impact on such funds."

Vaid takes the opposite view. "If I am investing in a close-ended fund for such a long period, I would look for high returns. That outperformance will only come from mid- and small-cap stocks. I would invest in an ELSS fund that has a fair amount of exposure to mid- and small-cap stocks."

Dhawan believes that for first-time investors a large-cap oriented fund is preferable. For others, the choice should depend on the overall capitalisation of the rest of the equity portfolio.

AUM. The assets under management (AUM) of the fund should not be less than Rs 500 crore. Says Dhawan: "Too small a fund corpus means that the fund does not get adequate management attention and economies of scale in terms of expenses do not come into play." Adds Sardesai: "If the fund size is too small, the management will always be evaluating whether to keep running the fund or merge it with another."

As for the maximum corpus size, there is some difference of opinion. Vaid prefers a fund whose corpus size is less than Rs 2,000 crore. "More than that and your mid- and small-cap exposure becomes very large. The scope for outperformance declines," he says.

Sardesai does not think that large size is a hindrance. "Today the total market cap is something like Rs 30 lakh crore. At present there is only one fund with an AUM of above Rs 5,000 crore. I would be worried if there were many funds with that large a corpus." Dhawan agrees. "Only mid-cap oriented ELSS funds would be difficult to manage if they became too large."

Other factors. One, avoid funds that have too large a portion of their corpus in cash. Two, the Sharpe Ratio measures how much returns a fund has generated for each unit of risk taken. A high Sharpe Ratio, together with the other factors mentioned above, is a good indicator of fund quality.

Returns. Most financial planners give a lot of importance to five-year returns though, they say, they would not necessarily overlook funds that have a three-year track record only. Says Sardesai: "That a fund has a five-year track record indicates it has survived the ups and downs of the market. The fund house is less likely to wind up its business or change the objective of that fund." Adds Vaid: "Good five-year (rolling) returns signify consistency. If the fund has maintained consistency despite the fund manager's departure, that is the mark of a good fund."

The bottomline: do not choose a fund on the basis of returns alone. First consider all the other criteria mentioned above. Only then look at returns. Then pick a fund that has beaten the category average return over the five-, three- and one-year horizon (or at least over two of these time spans).

Once you have made the investment, give the fund adequate time to prove its mettle. Stay with it for at least five years.

Finally, one needs to develop some perspective in the matter of returns. Says Vaid: "Don't look for the best-performing fund, but one that gives consistent returns over the long term. The best-performing fund keeps changing from year-to-year and nobody can predict that accurately. If you keep chasing the best performer, you will keep moving from one fund to another every year, which is not advisable. The returns you should expect from equities should equal average inflation rate plus GDP growth rate, which at present would be around 15 per cent. If your fund gives those returns, be happy." ♦

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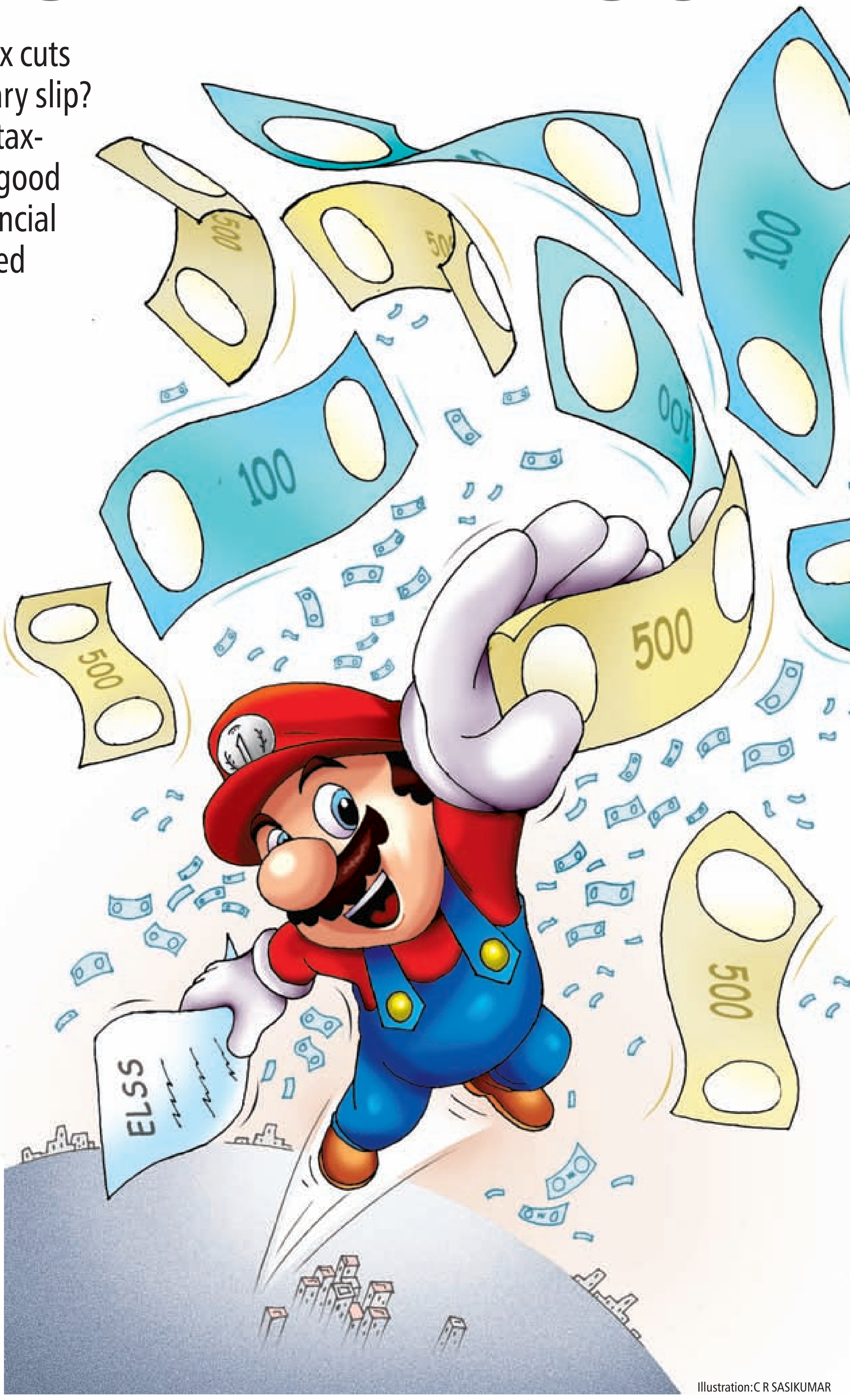

Illustration: C R SASIKUMAR

ELSS FUND OPTIONS YOU COULD CHOOSE FROM

Fund name	Returns 1-yr	3-yr	5-yr	Benchmark	Launch date	AUM (Rs cr)	R-square	Sharpe Ratio	Fund manager
SBI Magnum Taxgain	80.43	9.62	**31.16**	BSE 100	Mar-93	5,264.85	0.96	0.29	J. Shroff
Sundaram BNP P. Taxsaver	67.58	15.42	**27.22**	BSE 200	Nov-99	1,270.10	0.92	0.42	S. Ramanathan
HDFC Taxsaver	92.98	10.43	**26.65**	S&PCNX500	Mar-96	2,084.05	0.94	0.31	V. R. Kulkarni
ICICI Prudential Tax Plan	104.42	9.06	**23.87**	Nifty	Aug-99	1,011.02	0.87	0.3	S. Naren/R. Chandak
Franklin India Tax Shield	72.96	12	**22.7**	S&PCNX500	Apr-99	745.55	0.95	0.37	A. Radhakrishnan
Category return	**76.92**	**8.58**	**20.89**						
Birla SunLife Tax Relief 96	96.87	10.07	**20.29**	BSE 200	Mar-96	1195.7	0.94	0.31	A. Garg
Fidelity Tax Advantage	80.89	13.62		BSE 200	Jan-06	1,133.94	0.96	0.42	S. Kothari
DSP BlackRock Tax Saver	79.4			S&PCNX500	Dec-06	754.85			A. Maheshwari/M. S. Rajani

Source: *Value Research*

"Don't look for the best fund but a consistent one. The returns you should expect from equities should equal average inflation plus GDP growth rate — around 15 per cent. If your fund gives those returns, be happy"

SUMEET VAID, FFreedom Financial Planners