Balance fixed income, equity for good returns

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WITH INDIAN equity markets being volatile over the last one month, and banks raising interest rates very sharply over the last few weeks, it is very tempting to move out of uncertainty in equity markets to the stability of the familiar bank deposit. The fill it, shut it, forget it syndrome could make investors move back to the comfort of bank deposits, especially with interest rates on the upswing and the high level of predictability of maturity amount that bank deposits offer.

However, we believe that this shift from equity to fixed income should not be driven purely by the rise in interest rates, especially in an environment wherein inflationary pressures continue to be significant both due to domestic and international events.

Empirical evidence indicates that high inflation tends to accompany high growth, so don't be surprised by inflation rates that tend to be higher than historical averages.

Your fixed income portfolio which has traditionally tended to give you a negative real rate of return after accounting for inflation, therefore needs to be combined with assets that tend to give you a positive real rate of return like equities and real estate. The overall decision on equity and fixed income mix needs to be driven by multiple variables like time to realisation of financial goals, overall asset allocation plan, current underweight/ overweight position for equity/fixed income amongst other items. Your financial planner should be in a position to advise you about this.

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Once you have arrived at the appropriate mix of fixed income and equities, we believe that the current environment seems to have an anomaly wherein short term rates and long term rates have converged. In fact, in some cases short term rates are higher than longer term rates. We believe that this anomaly may not be a long term phenomenon and has been caused by a liquidity crunch that should start to ease over the next couple of quarters. Keeping this situation in mind, we believe that it would be a good idea to consider locking into products that are of a shorter term nature for a larger portion of your fixed income exposure, rather than longer term products. You could consider the use of:

- Short Term Income Funds — Most individual investors tend to consider mutual funds only for their equity exposure. For investors who are willing to digest short term volatility and mark to market impacts on their fixed income portfolios, it could be a good option for investors to consider short term income funds from mutual funds as they are currently running attractive accruals on their portfolios.

Please have a look at the portfolio carefully before you put monies into these funds so that you are comfortable with the ratings and risk profile of the underlying portfolio.

- Fixed Maturity Plans (FMPs) — These offerings from mutual funds would typically be available for periods of three months, six months and one year. Considering the tax arbitrage that they offer, especially for investors in the highest tax bracket, these could be excellent options to consider in the current tight liquidity environment.
- Bank deposits — For investors with unpredictable cash flows and liquidity that may be required at any time, it may be prudent to consider bank deposits even though they would probably offer at least 1 per cent lower than comparable FMPs, due to the liquidity that they offer.
- Corporate deposits — Shorter term options in this category could be considered, as they may offer marginally better rates than a bank deposit.

However, since these are unsecured, the quality of the corporate is critical.

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