Should I prepay loan or invest in equities?

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WITH THE withdrawal of RBI's accommodative monetary policy and a further rate hike in the next review meeting in mid-September, interest rates on retail loans have started to move upwards over the last few weeks. Both car loans and home loans have already got more expensive.

This has simultaneously been accompanied by rising stock markets in India and overseas, in spite of a fairly mixed news flow.

With interest rates overseas continuing to move at historic lows and no hint of a hike in the sight, liquidity has been gushing in from FIIs, who are taking stock markets to significantly higher levels.

In this environment, the crucial question that an investor — having excess liquidity and outstanding debt — faces: Should we prepay or invest?

Unfortunately there is no one size fits all solution. The decision needs to be driven by cost of loan and financial goals:

Cost of loans

Unsecured loans such as personal loans and credit card outstanding tend to be much more expensive than car loans and home loans. It would, therefore, be prudent to repay these loans rather than invest.

Home loans and car loans tend to be relatively cheaper, though most of the loans over the last few years have been of a floating rate nature or with teaser rates wherein the rates are fixed for a limited period of time.

Unsecured loans such as personal loans and credit card outstandings are expensive. It would be prudent to repay these loans rather than invest.

There is an expectation that interest rates could move up substantially from current levels as banks raise their floating rate benchmarks when faced by tighter liquidity and increased demand for funds.

In this scenario, it would be a good idea to prepay loans that have been taken recently, as the interest component on these loans would make up a significant component of equated monthly instalments.

For loans that have finished a significant portion of their tenor, it may be prudent to continue the loans especially if there are significant prepayment penalties involved. Also remember that most of these loans are in the form of reducing balances so the actual interest costs would need to be worked out with the help of your financial planner.

Financial goals

Most investors tend to have multiple financial goals such as retirement, children's education, medical exigency coverage, etc.

However, our experience has been that investors could be at different stages of achieving their financial goals. For investors, who are on plan as far as achieving financial goals are concerned, it would be prudent to prepay the loans to avoid any surprises through loan interest rates going beyond estimates.

For investors who are running significant gaps on their investment targets against financial goals, they may be forced to get more aggressive and invest in higher yielding securities like equities to try to get closer to their financial goals. While using leverage through continuing loans and investing in equities simultaneously comes with its own risks, this may be necessary unless investors are willing to compromise on their financial goals.

The writer is the founder of Plan Ahead Wealth Advisors Pvt. Ltd.