■ FIXED MATURITY PLANS

REFORMED FMPs BACK IN DEMAND

With interest rates likely to move up, investors are once again turning towards Fixed Maturity Plans of mutual funds. Sebi's reforms in the wake of the 2008 crisis have made them more robust

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WHILE Fixed Maturity Plans (FMPs) have had a poor run since the beginning of this financial year, now with interest rates poised to move up demand for these plans has revived. Of the 12 FMPs launched since April, nine have been launched in September and after. And of the Rs 1,600 crore mobilised by FMPs this financial year, Rs 1,400 crore has been collected since September. After investors burnt their fingers during the 2008 debacle (*see box: The crisis*), these products had fallen into disfavour. Why then are they back on investors' radar screens now?

The turnaround

INTEREST RATES POISED TO MOVE UP. With inflationary pressures increasing due to escalating food prices, interest rates are expected to harden. Economists believe that the Reserve Bank of India will first tighten liquidity with a CRR (cash reserve ratio) hike and then follow up with repo and reverse repo rate hikes. These could come anytime between January and June 2010.

When interest rates move up, the net asset values (NAVs) of long-term debt funds get eroded. Investors then have two options — either to stay put and wait for the interest-rate cycle to turn, or to move to instruments like FMPs that enable them to capture the gains from rising rates.

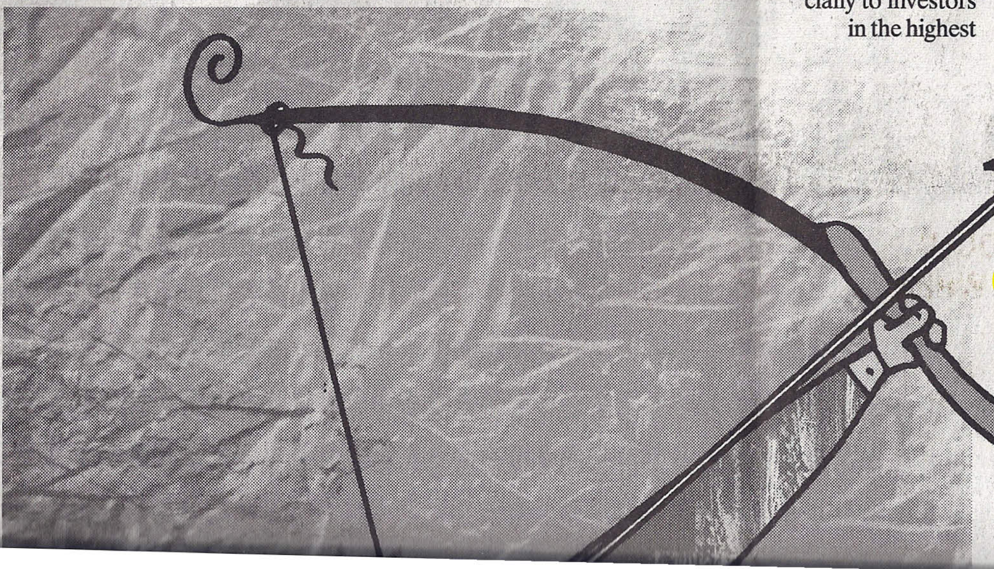
PREDICTABLE RETURNS. For a part of their portfolio investors want predictability in the returns they will get on maturity. Today that predictability comes in the short term from deposits, bank or corporate, and in the longer term from a few insurance products. FMPs are another category that offers predictable returns over the short term.

HIGHER RETURNS. Liquid funds offer returns of around 4 per cent, ultra short-term debt funds around 5 per cent, and short-term debt funds around 6 per cent (over a one-year horizon). Over a similar horizon FMPs would give you returns of 6.5 per cent or slightly more (depending on type of paper).

TAX ARBITRAGE. What makes FMPs attractive, especially to investors in the highest tax bracket, is the tax arbitrage available on them. If you invest in a bank deposit, then the interest earned is taxed at the marginal tax rate, which in the case of a person in the highest tax bracket works out to slightly over 30 per cent. In the case of FMPs, the long-term capital gains tax rate (on investments of more than one year) is lower — either a flat 10 per cent or 20 per cent with indexation. If your investments are spread over three financial years, then you become entitled to double-indexation benefit (*see box for more*), which makes them even more tax efficient.

When will you need the money?

Before investing in an FMP, consider your liquidity needs. According to Mumbai-based financial planner Vishal Dhawan, "Only investors who are sure that they will keep their money invested for the entire tenure should invest in an FMP. Don't bank on the liquidity available through exchange listing." Trading volumes in listed FMPs are likely to be low (as has been the experience with most exchange-listed funds). And with interest rates likely to move up, they will in all probability trade at a discount. If there is a



THE CRISIS...

IN October-November 2008, as Lehman Brothers collapsed and the global economy was gripped by a credit crunch, risk aversion and lack of liquidity spread to India as well. Simultaneously the credit quality of real estate companies deteriorated. Chasing higher returns, many FMPs launched in the latter half of 2007 and early 2008 had exposures to real estate companies and to securitised paper. The credit quality of many of these instruments was poor. After the liquidity crunch, a few real estate companies delayed the repayment of their debt. As news of their difficulties spread, FMP investors panicked and tried to redeem their investments, forcing FMP managers to sell the securities in their portfolios. Since the corporate bond market in India lacks depth, selling can be difficult at any time. Given the dodgy quality of some of their securities and the lack of liquidity in the market, selling became very difficult then. Many securities were sold at deep discounts, which drove the NAVs of these funds lower. When NAVs fell, more investors wanted to redeem, creating a vicious cycle. RBI then stepped in and asked banks to extend a line of liquidity to mutual funds so that they would not have to sell securities to meet redemption pressures. This restored a measure of stability to the system.

...AND THE REFORMS

- Sebi has made it compulsory for all FMPs to be listed so that an investor can sell at the stock exchange if he wants to exit mid-way. With this ruling, any redemption pressure will not negatively affect a fund house or investors who stay invested.
- The securities that FMPs invest in must mature within the tenure of the scheme. A 12-month FMP can't invest in 13-14 month securities. If there is a tenure mismatch and the security has to be sold, there could be mark-to-market loss if interest rates have moved up. With securities maturing in line with the maturity of the FMP, this risk is removed.
- The regulator has banned mutual funds from suggesting indicative yields for FMPs, which investors mistakenly treated as guaranteed returns.
- Finally, Sebi has made disclosure norms more stringent. All fund houses must now disclose FMP portfolios every month. If investors find signs of deterioration in the portfolio, they can exit.

chance that you may need the money before the 12-14 month horizon, invest in a short-term debt fund instead, suggests Dhawan.

Right investment horizon

FMPs with tenures ranging from five months to five years are available. According to Dhawan, "Interest rates are likely to go up. Put 60 to 70 per cent of your money allocated for these products in shorter-term FMPs of less than one year and the balance in FMPs of more than one year." For the latter, Dhawan suggests that while the tenure should be more than one year, they should mature before April 1, 2011. "A new tax code is being devised that could lead to changes in the way FMPs are taxed. We are asking investors to be cautious about FMPs that mature beyond April 1, 2011," he says.

If your investment horizon is less than a year, then the dividend option is most tax-efficient. For FMPs of over a year opt for the growth plan and avail of the indexation benefit.

Choosing the right FMP

Since Sebi's reforms, fund houses are not supposed to offer indicative yield on FMPs, nor can they reveal an indicative portfolio at the time of launch. So choosing the right FMP has become harder.

Though an indicative portfolio is not disclosed, the offer document talks about the kind of risk the portfolio will carry — low to medium, or medium to high. Look up this document. Says Sitaraman Krishnan, director, Crisil Fund Services: "If you are a highly risk-averse investor, you might want to invest in FMPs that only invest in triple-A paper."

Next, decide the duration for which you can spare your money and look for FMPs that are of matching duration.

Thereafter, check the pedigree of the fund house. Choose one that has a conservative style and does not court unnecessary risk.

Next, you would perhaps like to determine the likely returns. Once you have decided on the tenure, check what yield triple-A bonds are offering over that time horizon. An FMP's expenses would be in the range of 25-50 basis points. Reduce this from the yield on triple-A paper. This will give you an estimate. Over a one-year horizon, a triple-A FMP today is likely to give returns of around 6.5 per cent. FMPs investing in lower-quality securities would yield slightly more.

Some FMPs come with a rating from agencies like Crisil (but this is not mandatory). If rating is available, look it up.

While FMPs will not right away capture their former glory — they had touched an AUM of Rs 1.4 lakh crore in the latter half of 2008 — more FMPs are likely to get launched in the second half of the year. Says Sitaraman: "Today the credit quality of portfolios is looking better than a year earlier. Now FMPs don't typically have real estate exposure. That is a clear differentiator." Investors looking for higher post-tax returns may invest in these reformed products. ◆

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What is double indexation benefit?

ON long-term capital gains (levied if you have invested for more than one year) from FMPs, you can pay either a flat 10 per cent tax or 20 per cent with indexation. To avail double-indexation benefit, you will have to buy an FMP today, that is, in financial year 2009-10, but it must mature after April 1, 2011. From purchase date to maturity date the investment must straddle three financial years. Thus you are able to index the purchase price over three financial years even though you have been invested for only 18 months. When you do so, the difference between your pre-tax and post-tax return becomes small.

Formula for calculating taxable gain: Amount on maturity - (Amount invested x Inflation index for redemption year/ Inflation index for investment year). 20 per cent of this would be the tax liability. The index used for this calculation is the cost inflation index. Today trying to avail of the double-indexation benefit entails some risk due to the impending changes in the tax code.

Illustration: C R SASIKUMAR