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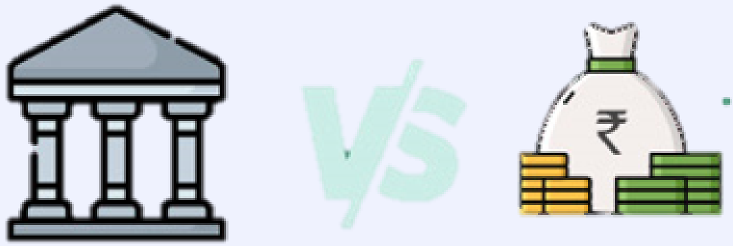
Debt Mutual Fund
Vs
Fixed Deposit (FDs)

Bank Fixed Deposits (FD) is the traditional investment vehicle for most Indian households. Fixed deposits are often considered the safest investment option and a large portion of Indian investors still have their savings deployed in Bank fixed deposits. But are fixed deposit the only investment avenue? Also, falling interest rates on FDs over the last 2 decades has been the reason to look for alternatives. A viable option to go for are debt mutual funds. Let us analyse the main difference between debt funds Vs FD.



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Risk

FDs pay back the principal amount along with accrued interest on maturity. the bank provides assurance of capital safety and as such, FDs are thought to be risk free investment.

Debt mutual funds invest in debt and money market instruments like, commercial papers, certificates of deposits, corporate bonds, Government bonds etc. Debt funds are subject to market risks and there is no assurance of capital safety. There are two kinds of risk in debt funds – interest rate risk and credit risk.

Returns

FDs pay a fixed rate over the FD term. FD interest rates have been declining for several years. Unlike FDs, debt funds do not give assured returns. Returns of debt funds are market linked. Summing up with a Illustration:

Note: For simplicity in calculating LTCG, it is assumed that withdrawal from debt funds is made after the end of the year. It is assumed that in the case of Fixed Deposit, the annual interest is re-invested at the same rate of interest and income tax is paid at the end of the investment term. In case of debt funds long term investment is considered i.e., 3 years. Income Tax Rate is 30%. Indexation calculated based on the last available CPI index.

Pre-Tax Return	**Fixed Deposit**	**Debt Mutual Fund**
Investment Amount	Rs .1,00,000	Rs.1,00,000
Investment Period	5 years	5 years
Assumed Return	5.00%	5.00%
Redemption / Maturity Amount	1,27,628	1,27,628
Total Interest / Capital Gain	Rs.27,628	Rs.27,628
Assumed Indexation Rate	NA	4.00%
Indexed Cost of Investment	Rs.1,00,000	Rs.1,21,665
Taxable Income	Rs.27,628	Rs.5,963
Applicable Tax Rate	30.00%	20.00%
Tax Payable	Rs.8,288	Rs. 1,193
Post Tax Returns	Rs .19,340	Rs. 26,436
Post Tax IRR	**3.60%**	**4.80%**

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Liquidity

Both are highly liquid. There is no lock-in. However, some banks may charge penalties for premature FD withdrawals. Debt fund redemptions within the exit load period will attract exit load which is charged on the redemption amount. Some debt fund schemes e.g., overnight funds do not charge any exit load.

Taxation

The interest from bank fixed deposits is added to your taxable income and taxed as per your income tax bracket. Short term capital gains in debt funds (investments held for less than 36 months) are taxed like FDs (Basis the income tax slab of the investor). Long term capital gains in debt funds (investments held for more than 36 months) are taxed at 20% only after allowing for indexation benefits. Debt funds are more tax-efficient as compared to bank FDs if you fall in the higher income tax bracket and have an investment horizon above three years.v

Conculsion

If capital safety and assured return is of paramount importance then FD is the investment option.

However, debt mutual funds provide superior risk adjusted return and taxation benefits and that is the major advantage of debt mutual funds if Debt Fund vs FD is compared.

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