

HOW THE RATE HIKE AFFECTS YOU

Find out about the investment avenues you should choose in order to make the most of the recent hike in rates by the RBI

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As the largest commercial bank in India, the State Bank of India is seen as a trendsetter in the banking sector. So, when it hiked the deposit rates on some maturities by 100 basis points three weeks ago, many expected other banks to follow suit. However, most of the banks have not done so yet. Many investors are sitting on cash, waiting for the banks to announce higher deposit rates before they invest in fixed deposits.

Will fixed deposit rates move up? Experts don't think so. The recent 50 basis point hike in repo and reverse repo rates by the RBI is likely to push up lending rates, but there's a very slim chance that deposit rates will also be affected. "Banks have been able to achieve the RBI's target for mustering deposits, so they may not feel the need to raise rates any further," says Arindam Ghosh, vice-president and head of retail sales, JP Morgan Mutual Fund. The deposit rate growth of banks, which was 17.4% in April this year, touched 18.4% in July. "Banks are comfortable on the deposit growth front. It's the credit growth that is pinching," says Dipen Shah, senior vice-president and head of research, Kotak Securities.

Waiting may prove costly

For those sitting on the sidelines, the wait for better rates could prove costly. They are losing out on an opportunity to earn 9-9.5% even as their money idles in the bank account, earning a piffling 4%. What's more, inflation is chipping away at its purchasing power with every passing day. At an inflation rate of 9% per year, the purchasing power of ₹50,000 lying in your bank account, reduces by over ₹200 every month. In three months, its value would be down to less than ₹49,400.

Some experts believe that the RBI may hike rates again by 25 basis points in the next policy review meeting in September. But by and large, fund managers think that the rates are very near the peak. The average maturity of holdings of income and gilt funds, which had been consistently declining in the past one year, has started rising. This shows that debt fund managers are accumulating long-term bonds in their portfolios. The average maturity of income fund holdings declined from 45 months in October 2010 to a little over 17

months in April this year. The trend has reversed since and the average maturity now stands at 25 months.

Still want to wait for better rates before you take the plunge? You can avoid the corrosive effect of inflation by opting for short-term debt funds. In the past 3-6 months, the returns from these funds have been comparable with those from fixed deposits. The only hitch is that unlike fixed deposits, there is no assurance of returns in a mutual fund. However, since they don't hold long-term bonds, short-term debt funds are not sensitive to interest rate changes, and unless the fund has taken undue risks by investing in unrated bonds from dubious issuers, the returns are usually in line with the prevailing interest rates. They are also more liquid than fixed deposits. Within two days of applying for a redemption, the money is in your bank account. So, even if fixed deposit rates go up, you can still opt out of the debt fund and lock in at the higher rate in an FD.

You can also invest in fixed maturity plans of mutual funds. The indicative yield offered by these closed-ended funds is close to 10%. However, some of the tax advantages that the FMPs have been offering over fixed deposits may not be available after the Direct Taxes Code comes into effect from 1 April 2012. Under DTC, short-term and long-term capital gains from debt funds will be taxed at the same rate as income from fixed deposits. Still, debt funds have an edge in one important respect. Unlike in fixed deposits, the income is not taxed every year but only on withdrawal. What's more, you can still get the benefit of indexation under the DTC.

Don't overinvest in debt

Don't binge on long-term debt just because interest rates are high. The RBI action last week shocked the equity markets. The steep hike shaved off nearly 700 points from the Sensex in four trading sessions. Analysts believe some more pain could be in store in the coming weeks, but they also think that the RBI action will prove beneficial in the long term. "What the RBI has done may be bad for the equity markets in the short term, but good for the economy in the long term," says Ritesh Jain, head of investments, Canara Robeco Mutual Fund. "This is a decisive action and will prove effective in reining

inflation," agrees Mahendra Jajoo, executive director and head of fixed income, Pramerica Mutual Fund.

What this also means is that once the short-term problems are resolved and inflation is tamed, the stock markets could resume their upward march. "The positive factors outweigh the negatives at this point of time," says Shah. He says the interest rate cycle appears to have peaked, the monsoon has been near normal and the reforms process is back on track with the removal of procedural bottlenecks. "We are hopeful that significant reforms related to FDI in retail, diesel prices, pension funds and state electricity boards will be cleared in the monsoon session of Parliament, which starts this week," he says.

Though fund managers are equally bullish, they also want you to exercise caution. "The next 4-6 months will present good opportunities to buy into equity funds at low prices. Keep accumulating mutual fund units through SIPs," advises Jain. He also says that this may not be the best time to invest in sectoral, small-cap and mid-cap funds. "Small- and mid-cap companies managed to do well when the economy was growing at 9% and or-

der books of large companies were overflowing. In the coming years, when growth tempers to 7-8%, and the order flow slows down, only large-cap companies will do well," he says. So it's best to stick to the large-cap diversified equity funds. They will provide safe and steady returns in the coming years. We have identified the top five funds in this category. Choose any of these to start an SIP.

If you have a large amount to invest, Jain advises that you put it in a debt fund and then start a systematic transfer plan into an equity fund. "In this way, you get the best of both worlds—the SIP advantage in equity investing and safe and steady growth of the debt portion," he says.

Stocks and sectors to buy

The rate hike led to a sell-off in rate-sensitive sectors, such as banking, automobiles and real estate. Aneesh Srivastava, CIO of IDBI Federal Life Insurance, believes that in the coming months, some rate-sensitive stocks would be available at distressed valuations. "That would be a good time to start accumulating these stocks. Once the interest rate cycle turns, they will find their true value," he says. Srivastava also believes that inflation would peak by Diwali.

Shah is upbeat on the infrastructure, capital goods and banking sectors, as well as select IT companies, but he expects metal stocks to underperform as global commodity prices drift down. The real estate sector is also on his negative list. "It may be months, even years, before some real estate stocks reach their 2007 highs," cautions Shah.

"The RBI action may be bad for stocks in the short term, but it will be good for the economy in the long term. Keep buying with SIPs."

Ritesh Jain, Head of Investments, Canara Robeco Mutual Fund



"Lending rates could go up, but deposit rates are unlikely to rise much. Banks are comfortable on the deposit growth front. It's the credit growth that is pinching."

Dipen Shah, SENIOR VP and Head of Research, Kotak SECURITIES

BEST SHORT-TERM FUNDS

Fund name	Annualised return (%)		
	1-month	3-month	6-month
UTI Short-term Income	12.72	10.16	10.28
IDFC SSI ST Plan D	11.52	10.6	9.98
ICICI Pru Short-term	10.44	8.92	8.78
Baroda Pioneer ST Bond	10.44	9.08	9.00
Principal Income ST	10.44	9.36	9.28

As on 28 July 2011

Source: Value Research

BEST LARGE-CAP EQUITY FUNDS

Fund name	Returns (%)		
	1-month	3-month	6-month
DSPBR Top 100 Equity	4.61	13.87	17.74
Franklin India Bluechip	5.18	16.82	16.14
ICICI Pru Focused Bluechip Equity	8.43	19.80	NA
HDFC Index Sensex Plus	4.52	13.74	14.79
Kotak 50	1.57	9.23	13.94
Category average	2.12	9.20	11.63

As on 28 July 2011; returns over one year are annualised

Source: Value Research

