Rising rates tip the balance in favour of FDs, debt funds

Investors' strategies need a rethink in 2023 as long-term fixed income instruments are offering higher yields compared to other asset classes

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By Sachin Kumar

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MUMBAI: Rising interest rates have tipped the scales in favour of bank Fixed Deposits (FDs) and debt funds. Recent increases in rates on FDs by the banks, higher returns by debt funds and disappointing performance by the equity market have prompted investors to rethink their investment strategy.

With interest rates expected to peak during the second half of this year, the time is ripe for risk-averse investors to increase their allocation in FDs and debt funds, believe experts. "We are somewhere close to the peak of the interest rate cycle and rates should touch their peak in 2023. So, it is a good idea for an investor to start locking in a longer-term fixed interest rate. In the first half of the year, they should try to increase the allocation to the longer-term fixed income instruments," Vishal Dhawan, Founder of Plan Ahead Wealth Advisor told TNIE.

FD rates over 7%

Interest rates on bank FDs have shot up recently following the multiple repo rate hikes by the Reserve Bank of India last year. In a bid to reign-in high inflation, the central bank has raised the repo rate by 225 basis points (bps) since April 2022. The RBI is widely expected to raise the repo rate by 25 bps in its next meeting in February.

Reacting to repo rate hikes, banks have hiked rates on FDs. The interest on FDs maturing in 1 to 5 years is now ranging between 7% and 8.1%. Debt funds are another attractive option for investors.

"It is a good time for investors to start locking in yield in fixed deposits and more so through debt mutual funds. As inflation and consequently interest rates stabilise over the next few years, accrual income will be beneficial for fixed income investors. From a taxation perspective, it is advisable to invest through mutual funds to participate in this view," Harish Menon, Co-founder and Head of Investments and Product Research at House of Alpha, a financial planner and wealth management advisory firm, said.

"Considering the yield curve, 3-5 years term duration is offering the best value now. Investors can lock the yield and benefit by following a rolling down the yield curve strategy. Debt index funds are the most optimum product in this segment," he added.

Debt funds offer better post-tax returns compared to FDs to investors if they stay invested for three years or more. Experts say that the decision to choose between FDs or debt funds depends on the investors' tax bracket. "For those in higher tax brackets, debt funds will be more efficient because of the indexation and capital gains benefit that is available for long term debt while those in lower tax brackets can consider either bank FDs or highly rated corporate deposits," added Dhawan.

Subdued equity market returns in 2023

Rates on small saving schemes of the government have also been raised. The Ministry of Finance has hiked the interest rates on some small savings schemes for January- March quarter and they are now offering up to 8% interest.

While rates on term deposits have gone up, the equity market has not performed as per investors' expectations as BSE Sensex and NSE Nifty index delivered 4.4% and 4.3%, respectively in 2022. In the first week of new year, Sensex has shed about 1,141.50 points (1.87%) while the Nifty has declined 242.45 (1.34%).

"FDs of over 7% interest can marginally affect the inflows to capital market from small investors in 2023-24. But more than FDs, competition is higher from government and corporate debt instruments, which can provide decent yields of 8% to 10% at low risk," Vinod Nair, Head of Research at Geojit Financial Services said.

"The future view of the domestic stock market in 2023 is neutral due to recessionary and high valuation. In 2023–24, we can expect risk-averse investors to invest in interest-earning categories, including debt schemes, in anticipation of fixed returns compared to a volatile market," he added.

Several companies have also announced the launch of Non-Convertible Debentures (NCDs) offering over 10% yield to investors.

The public issue of secured NCDs of InCred Financial Services opens for subscription on Monday. The NCDs offer coupon rates ranging from 9.45% to 10% per annum with quarterly and annual interest options. Similarly public issues of NCDs of IIFL Finance and Indiabulls Commercial Credit are also open for subscription.

Time to lock in high rates

4-8.1% Interest on FDs of banks maturing in 1-5 years

6.6-8% Interest rate on small saving schemes

8-14% Return on debt funds in 3 years

4.4% Rise in BSE Sensex in 2022

0.25% Expected repo rate hike by RBI in February