Over 200 debt mutual funds gave higher returns than bank FDs. Time to break your deposits?

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With over 200 debt mutual funds outperforming bank FDs and expectations of a rate cut in 2025, mutual fund experts recommend using a combination of constant maturity gilt funds and short-term funds as part of the debt portfolio allocation.

"With expectations of interest rate cuts in 2025 and greater clarity expected on policies in the US and interest rate direction there, we would suggest using a combination of constant maturity gilt funds and short-term funds as allocations in the debt portfolio," recommends Vishal Dhawan, CEO of Plan Ahead Wealth Advisors, a wealth management firm in Mumbai.

ET Mutual Funds analysed the two-year performance of all debt mutual fund categories alongside the interest rates on fixed deposits offered by the PSU bank, SBI, during the same period.

Around 215 debt mutual funds outperformed the bank deposit rate of 7% offered by SBI over the past two years. The top two performers were from the credit risk fund category. DSP Credit Risk Fund delivered the highest return of 11.65% over the last two years, followed by Aditya Birla SL Credit Risk Fund, which provided 9.45% during the same period.

SBI Long Duration Fund delivered a 9.44% return in the mentioned time period. Aditya Birla SL Long Duration Fund and DSP Strategic Bond Fund each offered an 8.88% return over the last two years.

Bandhan G-Sec-Constant Maturity Plan and Bandhan G-Sec-Invest offered returns of 8.67% and 8.66%, respectively, in the mentioned period. Kotak Savings Fund and Invesco India Medium Duration Fund each provided a 7.01% return during the same period.

After the outperformance by debt mutual funds, experts recommend that investors in higher tax brackets benefit from deferring taxes by staying invested in debt mutual funds until they actually need their money. Investors in higher tax brackets should consider debt mutual funds as a tax-efficient investment option.

"Investors in higher tax brackets can benefit from deferring taxes by staying invested in debt funds until they actually need the money, unlike bank fixed deposit investors who must pay taxes on an accrued basis, even if they don't need the funds. Therefore, investors in high tax brackets could consider using debt funds once their deposits mature," said Dhawan.

In the last year, around 254 debt mutual funds outperformed bank FDs. Approximately 18 funds offered double-digit returns during the same period. Aditya Birla SL Credit Risk Fund delivered a 12.13% return in the past year. HDFC Long Duration Debt Fund and SBI Long Duration Fund provided returns of 11.91% and 11.74%, respectively, over the last year.

Many experts believe that categories likely to gain focus this calendar year include dynamic bond and gilt funds in debt. "In 2025, mutual fund categories likely to gain focus include dynamic bond and gilt funds in debt, benefiting from potential rate cuts and stable returns," said Sagar Shinde, VP of Research at Fisdom.

Now, the question arises: If you are considering debt mutual funds for investment over fixed deposits, what strategy should you follow?

Experts recommend that the choice of debt mutual funds depends on the investment time horizon and the investor’s tax bracket. If the investor is in a higher tax bracket, they can allocate up to 50% of their portfolio to debt mutual funds and consider arbitrage or hybrid funds with lower net equity exposure for a portion of the remaining fixed-income allocation, as these offer higher tax efficiency. However, fixed deposits should be restricted to a portion of emergency needs.

“The decision on how much to allocate to debt funds depends on the investment time horizon and tax bracket of the investor. Investors in higher tax brackets can benefit from using debt funds for up to 50% of their portfolio and consider arbitrage or hybrid funds with lower net equity allocations for a portion of the rest of their fixed income exposure due to higher tax efficiency. Fixed deposits should be restricted to a portion of the emergency needs aligned with the investor's goals,” Dhawan recommends

FD vs debt mutual funds

When comparing fixed deposits (FDs) and debt mutual funds, it becomes clear that FDs are perceived as low-risk investment options by investors. They provide guaranteed returns over a specified tenure, whereas debt mutual funds involve slightly higher risk due to interest rate fluctuations.

A significant distinction between the two lies in taxation. Tax-saving fixed deposits qualify for deductions under Section 80C of the Income Tax Act, offering tax benefits. Conversely, debt mutual funds do not provide such exemptions. Following the amendments to the Finance Bill 2023, gains from debt mutual funds are taxed at the investor’s applicable income tax slab rate.

Similarly, fixed deposits are taxed based on the investor’s income tax slab rate. However, every time an FD matures and is renewed, Tax Deducted at Source (TDS) is applied. In contrast, debt mutual funds do not attract TDS. Taxes are only payable when the investor redeems their units, providing more flexibility in tax planning.

One should always consider their risk appetite, investment horizon, and goals before making investment decisions.