Bank FD rates drop: Time to rethink your mutual fund investment strategy?

By Surbhi Khanna, Published on 17th April 2025

With banks slashing FD rates and investors looking for different investment avenues, a market expert recommends that if one is comfortable with a small level of market risk and aiming for returns that beat inflation and FDs, mutual funds — especially debt, arbitrage or hybrid funds — can offer better long-term growth.

“Those who wish to make higher returns and have a slightly higher risk appetite and those seeking better post-tax returns in falling interest rate scenarios as with interest rates likely to decline after an RBI rate cut, FDs may offer lower returns, whereas debt mutual funds (especially long-duration ones) can benefit from falling yields,” said Vishal Dhawan, CEO, Plan Ahead Wealth Advisors, a wealth management firm in Mumbai.

“If you're in a higher tax bracket, FDs are taxed at your slab rate, and equity-oriented BAF/DAF and arbitrage funds are more tax efficient and mutual funds provide exposure to a diversified set of securities—across equity, debt, or a mix—helping manage risk better than a single FD,” he added.

Post rate cut by RBI in its last policy meet, banks like SBI, Bank of India, Yes Bank, Indian Bank, and few other banks have reduced their repo-linked lending rates upto 25 basis points. This rate revision affects the tenure across 1 to 3 years.

Arbitrage funds are taxed like equity mutual funds. This means they qualify for long term capital gains tax of 12.5% if investments are held for more than a year. If investments are for less than a year, short term capital gains tax of 20% will be applicable.

In case of equity mutual funds, the units with a holding period of more than 12 months were taxed at 15% (STCG) and 10% (LTCG). However, in the last Budget announcement it was decided that these units will be taxed at 20% (STCG) and 12.5% (LTCG).

Finance Minister Nirmala Sitharaman in the last Budget made no change for the debt mutual funds which continued to be taxed as per the tax slab.

RBI in its last policy meeting reduced the repo rate by 25 basis points to 6%. This is the second consecutive rate cut by the apex bank in the current calendar year and the first one in the current financial year.

This marks the second consecutive cut under Governor Malhotra. In February, the apex bank had reduced the repo rate by 25 basis points. Before this, the repo rate was held at 6.5% for 11 consecutive meetings.

Post rate cut by RBI, the expert believes that with inflation easing and growth slowing, the changed stance signals potential rate cuts ahead and investors can consider adding debt funds or locking into corporate bond funds with good credit quality and longer duration.

Commenting on whether one should move to dynamic asset allocation or balanced advantage funds, the expert mentions that these funds invest in both equity and debt without being constrained by a fixed allocation and fund managers have the flexibility to adjust the allocation between equity and debt based on prevailing market conditions.

If one is planning to shift to arbitrage funds, experts advise that arbitrage funds have delivered stable returns thus far during recent market volatility and for short-term goals of 3 months to 1 year, they offer relatively steady post-tax returns.

“Arbitrage funds can be an ideal choice to park money for the short term as they offer equity taxation benefits which are lower for investors in higher tax brackets, compared to FDs and debt mutual funds,” Dhawan adds.

The arbitrage funds in the current calendar year have offered an average return of around 2.06%, dynamic asset allocation and balanced advantage funds gave a negative average return of 2.42% in the same period.

On the debt side, corporate bond funds have delivered an average return of 3.20% in the current calendar year so far. Long duration funds and medium to long duration funds gave an average return of 4% and 3.62% respectively in the same period whereas ultra short duration funds gave an average return of around 2.26% in the same period.

After seeing the performance of these funds in the current calendar year so far and knowing the taxation and other aspects, if you are willing to invest in dynamic asset allocation and balanced advantage funds, Dhawan mentions that someone who cannot actively manage asset allocation can consider investing in Dynamic Asset Allocation Funds (DAFs) or Balanced Advantage Funds (BAFs), as these funds automatically adjust their equity and debt exposure based on market conditions.

“Taxation does not occur in this process at investor level for rebalancing. In recent years, we’ve seen significant flows into thematic and small-cap funds, which are now trading at premium valuations. In contrast, DAFs and BAFs offer broad-based, diversified exposure, making them a more suitable choice for first-time or conservative investors. However, it's essential to understand the underlying asset allocation model before investing,” Dhawan mentions.

“For a short-term horizon of 1-3 years, arbitrage funds provide relatively stable post-tax returns. You can stay invested in arbitrage funds for now and gradually shift to riskier assets like equity through an STP (Systematic Transfer Plan) when valuations become more attractive, or opportunities arise,” Dhawan advises the investors who are willing to invest in arbitrage funds.