

Safety, Liquidity and Return

Are you compromising on your return?

Despite India having one of the highest savings rates in the world, the Indian investor is deprived of even the barest minimum return that he should earn on his investment. Making an investment should be governed by three basic criteria: it should be safe; there should be liquidity; and it must give you returns. The Indian investor has become defensive due to a lack of choice, thereby focusing more on safety and liquidity than on the returns he should be getting. In the interests of safety, investors compromise on return.

There are several avenues of investment, the most obvious of them being bank fixed deposits and savings accounts. Small savings schemes, such as Relief Bonds (RB) and Kisan Vikas Patra (KVP), and Post Office monthly income schemes and term deposits, are popular. The Public Provident Fund is another popular investment avenue. Lastly, investments in capital markets are made by way of direct purchase of shares on stock exchanges or indirectly through mutual funds and subscription to Initial Public Offerings (IPO). A surrogate method of investment is also through purchase of endowment life insurance policies. Besides insurance cover, these policies are viewed as savings.

Let us try and analyse here the pros and cons of different forms of investment within the parameters mentioned, that is, safety, liquidity and return. Data gathered on the pattern of saving by the Indian household over the last three years shows that almost half the total savings 49.6% is invested in areas which do not yield a return that can even cover the basic cost of living. The headline inflation rate in the country during the last six years was 5.15 per cent on a 52-week average, the Consumer Price

Index grew by an average of 4.29 per cent. In the last six months, inflation has been around 4.75 to 5.25 per cent. Of the total deposits with banks, 25 per cent constitutes Savings Account deposits on an average. Banks offer 3.5 per cent p.a. interest on savings account, which is insufficient to cover inflation, and therefore does not generate any return to the investor.

In 2001-02, banks were offering 5 to 7 per cent interest on FDs with one year maturity, and during the year, the inflation rate was 7.2 per cent. Depositors were therefore getting a negative rate of return. In 2001-02, due to an overall decline in the economy, inflation remained subdued at around 3.6 per cent and depositors were able to get a return on their investments in banks. From 2004-05, inflation has started picking up, but due to the government's benignly indifferent interest rate policy the interest rate has remained at earlier levels, with investors losing money on their FD investments.



For FDs up to 6 months' maturity, banks are offering an interest rate of 4.5 to 5.5 per cent, which is lower than the current inflation rate of 5.26 per cent. Depositors are switching to short-term deposits. From 1989-90 to 2004-05, 72 per cent of the deposit mobilized by commercial banks in India had more than two years' maturity. But an analysis of the latest RBI figures on the maturity pattern of deposits shows that in 2004-05, about 63 per cent of the deposits mobilised by commercial banks was for a period of up to two years while only 37 per cent of the deposits was for longer periods. Changing lifestyles, an increase in other asset prices and consumer spending patterns are some of the reasons for this. Depositors, increasingly, want to stay liquid.

Now let us look at the security aspect. Legally speaking, bank deposits are covered by insurance only to the extent of Rs 1 lac. That is, irrespective of the amount deposited, if the bank goes bankrupt, the depositor will get only Rs 1 lac. That too will happen only if the bank has paid the insurance premium to the insurance company. History has shown that nationalized and scheduled banks have never closed down; poor financial management will lead to a temporary moratorium on the bank and subsequent merger with another strong bank. However, depositors have not been so lucky in the case of co-operative banks.

Liquidity is at the cost of return. If you break your deposit prematurely then there is a certain reduction in the returns that you earn. Hence, one ends up taking a loan against Fixed Deposit rather than break it. Income from interest does not enjoy any special is fully subject to tax.

Small savings enjoy the highest rating so far as safety is concerned since they are guaranteed by the Government. The average return is 8 per cent on such investments and subject to tax. Hence, after tax the return works out to about 5-7 per cent, depending on the tax bracket one is in. This again, compared to the inflation, may just be enough to cover the cost of rising prices and not generate any returns. These schemes have a lock period, and hence, are low on liquidity parameters. As regards Public Provident Fund there is a limit on investment and there is a lock in the period, 15 years. Thus, it is not available to you in times of need.

Lastly, let us examine equity investments. The average annualized return has been 27 per cent for one year, 18 per cent over 5 years and 19 per cent for 15 years and 16 per cent for 23 years. (Source Business World: Essential Guide to Carefree retirement). During the last one year, the market has been particularly bullish. Investment for one year in NSE Nifty index-based shares has generated 43.16 per cent return as on August 2006. Besides, shares are most liquid and guaranteed T+2 settlement system, and coupled with a robust depository system, the movement of funds and shares is the fastest as compared to any other form of investment. Equity investments can be done directly or through mutual funds.

Taxation on capital gains arising out of equity investments enjoys the highest benefits. Investments for a duration exceeding one year are tax-free and those for less than a year are subject to a taxation rate of 10 per cent. Dividends earned on such investments are also tax-free.

The safety aspects of equity investments need to be understood. They are subject to risk. An informed investor is one who understands these risks and manages them by minimizing them. With a disciplined approach to investing, wherein we have targeted returns and stop loss levels, it is very difficult to lose money. The successful investor is one who has conquered greed and overcome the fear of loss. So the next time you are about to put your money in the bank or post office, remember there are better options available.

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