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Tax-free Bonds Lose Sheen

Recent run-up in their prices and hopes of rate cuts prompt investors to shift to gilt funds

Prashant.Mahesh
@timesgroup.com

Mumbai: Savvy investors are trimming exposure to tax-free bonds following the run-up in their prices in the last few months. Many of them are shifting money to long-term gilt schemes of mutual funds on hopes they would perform well over the next six months. Gilt funds invest in government bonds or securities.

These investors had poured money into tax-free bonds of state-owned entities such as NHAI, PFC, and IRFC between 2011 and 2013. Now, with prices of these bonds rising faster than that of government securities, they see an opportunity to make a quick buck in gilt schemes.

"The appreciation in tax-free bonds has been much faster than government securities. This is primarily because there is no fresh supply of tax-free bonds as the government has not issued any notification for them in this financial year," said Vikram Dalal, managing director, Synergee Capital.

The average yield on tax-free bonds is now 6.9-7%. The yield on 10-year benchmark is now 7.85-7.9%. Investors are expecting government bond yields to fall once the Reserve Bank of India starts cutting interest rates. Bond yields (or rates) and prices move in opposite direction — when interest rates or bond yields fall, bond prices rise. Investors in gilt funds are hoping to benefit from a rally in government bond prices.

Adding the coupon of 7.9% to the likely capital appreciation of 7-8%, investors could earn as much as 15% in 2015 from gilt funds. "Interest rates could go down by 50-100 basis points over the next 12-18 months," says Dwijendra Srivastava, fund manager, Sundaram Mutual Fund. He expects the first round of interest rate cuts to happen in the first quarter of 2015. Inflation based on the consumer price index (CPI) eased to 5.52% for the month of October, while Brent crude is down to about $67 per barrel, down from $114 in June, adding hopes that a rate cut will happen soon.

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Financial advisors are recommending their rich clients to sell tax-free bonds issued in the financial years 2011-12 and 2012-13, which have completed at least a year and will, therefore, not attract any short-term capital gains tax. Long term capital gains in bonds are taxed at 10%. These bonds are traded on the stock exchanges.

The 8.3% NHAI N1, issued in January 2012 and maturing in 2022, trades at Rs 1,085, giving a yield of 6.95%. Similarly, IRFC N2, issued in February 2012 with a coupon rate of 8.2% and maturing in 2027, trades at ₹1,107, giving a yield of 6.93%. Investors in the NHAI bond issue will have absolute returns of 30% in less than three years.

Medium and long-term gilt funds fetch a yield to maturity of around 8.2-8.5%. "Such gilt funds could give you a 7-8% capital appreciation if interest rates are cut by 100 basis points over the next one-and-a-half years," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.