Don’t switch to balanced funds just for tax gains

Many traditional debt mutual fund investors and medium to high net worth individuals are moving to equity-oriented balanced funds to tackle the challenge posed by the change in taxation on debt investments in the Budget, say investment consultants. Long-term capital gains from equity-oriented balanced funds that invest above 65% of the portfolio in equity are tax-free after a year, whereas long-term capital gains are taxed at 20% in debt mutual funds after three years. Short-term gains are taxed at the rates applicable to the individual taxpayer.

"Most people don't invest in debt schemes with a three-year perspective. They typically park shortterm money in debt funds. These people are shifting to balance funds because of the change in taxation," says Surajit Misra, executive vice-president & national head —mutual funds, Bajaj Capital. Balance funds category offered around 40% returns in the last year. However, financial advisors say that investors are going to risk changing their asset allocation and risk profile if they get into balanced funds without doing their home work.

"An existing investor will have to redo the entire allocation if he wants to shift his debt investments to balanced funds. Most of these schemes are equity-oriented funds, which invest around 70% in equity and the rest in debt. Investors will have to sell their existing investments, and redo their portfolio. I really doubt how many of them will be able to pull that off," says Suresh Sadagopan, principal planner, Ladder7 Financial Advisories. He adds that investors, in their single-minded quest for taxadjusted returns, should not miss the fact that investing in equity calls for a higher risk appetite.

According to a senior official at a large mutual fund house, the industry has taken notice of the newfound interest in balanced funds and they are devising strategies to attract investor attention. "Unfortunately, fund houses have never focused on balanced funds in the past. Except for a scheme, none has any traction," says Misra. He is referring to HDFC Prudence, which manages around Rs 5,834 crore as on June 30, according to Value Research, a mutual fund tracking entity.

Savvy investors say that they have been always investing in balanced funds to make better post-tax returns. "I have been investing in balance fund schemes for a while now. Return from your entire debt investment is tax-free after a year. Also, you can book shortterm capital losses in a balanced fund," says a savvy investor, who does not wish to be named.

Get Balancing Act Right

Experts say that balanced funds have always been recommended to novices in the stock market. These schemes invest in a mix of equity and debt, and allows the fund manager to jiggle the portfolio and contain the turbulence in both equity and debt market.

The basic idea was that investors will be able to take exposure to equity without fearing a total loss of capital. However, over the years, many experts have concluded that it is better to separate equity and debt investments, as it helps monitor the performance of the portfolio better.

"My big problem with these schemes has been measuring their performance. You really don't know how the equity or debt part of the portfolio performed. All you have is an overall return. Also, some of these schemes invest in large-cap or small-caps, but the benchmark is always Crisil Balanced index," says Sadagopan, who believes that most investors tend to overlook this aspect as they are happy with the overall returns.

Many experts also feel that in their quest for better post-tax returns, many average investors may be overlooking the risk associated with balanced funds. In short, you can explore these funds, but be fully aware that most of the funds we are talking here allocate 65% or more to equity.

"Investors should remember the risk associated with stocks. If they can't stomach the risk, they should consider investing in arbitrage funds, which also don't have longterm capital gains tax after a year," says Sadagopan.

Arbitrage funds try to explore the arbitrage opportunity between spot and future markets, and the fund category has returned 9.33% in the last year.

(Economic Times)