Tax-free bonds: High rates matter, so does liquidity

Tax-free bonds are back, after a brief lull of 10 days. Investors, who missed the opportunity earlier to invest in similar issues, can consider three issues from India Infrastructure Finance Company (IIFCL), Indian Renewable Energy Development Agency (IREDA) and Ennore Port that will open for subscription this week.

According to investment consultants, every investor, especially those in the higher tax brackets, should consider investing in these bonds because they are offering extremely attractive rates (probably the best for many years) and you don't have to pay tax on interest earned from them. Also, investors need not worry about safety of their investments in these bonds as all three companies have the backing of the government.

All investors have to do is to consider their liquidity needs and choose an appropriate candidate, they say.

"The liquidity of the bond is very important if you have to exit the bond before the end of its tenure," says Ajay Manglunia, head (Fixed Income), Edelweiss Capital. His advice: if you think you may need money before the maturity of the bond, opt for IIFCL bonds. This is because the issue size of IIFCL is bigger and it may be traded more on the exchanges.

However, if you are looking for higher returns and intend to hold your investments till maturity, you should pick Ennore Port. These issues differ in size, rating and interest rates paid. The issue size of IREDA is Rs 1,000 crore, Ennore Port (Rs 500 crore) and IIFCL (Rs 2,800 crore). IIFCL is AAA-rated, IREDA is AAA (SO), while Ennore Port is AA-rated.

Ennore Port offers the highest interest of 8.61% for 10 years and 9% for 15 years and 20 years. IREDA and IIFCL offer 8.41% for 10 years and 8.8% for 15 years and 20 years. IIFCL is offering its third tranche this financial year while IREDA and Ennore Port have come up with their first issue this financial year.

Importance of Liquidity

Investors tend to get carried away by interest rates. In their sole aim to pocket the maximum rate possible, they tend to overlook the rating and tenure. This could pose a serious problem while investing in tax-free bonds. Investors need to be extremely careful about their liquidity needs because tax-free bonds come in longer tenures of 10, 15 and 20 years.

If for some reason you need the money before maturity, the only way out is to sell them on the stock exchange. If the bond is not traded frequently on the exchange, you may end up selling them at a big loss or at a discount.

"Past experience shows that smaller issue sizes tend to be illiquid, Liquidity dries up within a few days of listing as most retail investors hold till maturity," says Vikram Dalal, managing director, Synergee Capital. That is why experts like him advise investors to go for bonds with large issue size.

Dalal prefers IIFCL, followed by IREDA and Ennore Port. Issue size is extremely crucial for investors aiming to sell these bonds to take a capital appreciation as the interest rates start falling. Experts believe that once interest rates start coming down, these bonds will be in great demand and they could trade at a premium to their face value.

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