Debt Funds

Why in news?

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Indian debt funds market reached record size recently.

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What are debts and equities?

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- Debt instrument helps to raise loans by borrowing.
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- In return, the holder of debt instruments, are owed the amount of money borrowed along with the interest promised. e.g Bonds.
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- It involves less risk than equity investments and typically offers a correspondingly lower potential return on investment.
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- Equities also help to raise loans, but instead of owing back the money, partnership in the firm is offered based on the amount borrowed. e.g Shares.
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- It is riskier but has the potential to bring more returns if the firm makes profit.
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What are debt funds?

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- Equity funds invest mostly in shares of listed companies and debt funds invest in instruments like government bonds, commercial papers (CPs), certificate of deposits (CDs) and non-convertible debentures (NCDs).
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- The interest made from these instruments is shared among the investors after deducting the fund-management charges.
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- The gains made on the investment in debt schemes are taxable.
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- If the securities are sold within 3 years, it is considered short-term wherein the gains are added to the income of the investor and taxed as per the applicable tax bracket.
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- If the securities are held for more than three years before selling, there are long-term capital gains tax.
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- The tax rate is 20% with indexation and 10% without indexation.
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What are the different types of debt funds?

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- Debt funds can be classified on the basis of the tenure of the bonds or instruments in which they invest.
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1. **Liquid funds -** They invest in instruments that have a tenure of less than 90 days.
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2. **Short-term funds -** They invest in instruments that typically have a tenure of three to six months.
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3. **Corporate debt -** They could have a tenure of up to three years.
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4. **Long-term funds -** They invest in bonds that have a tenure of three to five years or even more e.g Government bonds (G-Secs).
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What are the advantages?

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- They are generally used by banks and corporates for their treasury operations.
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- They offer more return than bank fixed deposits.

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- So they are popular among high net worth individuals (HNIs) to park their money temporarily before moving to other asset classes.
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- This enables the investors to indirectly invest in instruments like government bonds, where direct retail investment is not possible.
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- The risk is also higher compared to the safe FDs that offer assured returns so the number of retail investors in debt funds are still very little.
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- In the case of bonds, the price could fall due to various reasons thereby impacting its price and its return.
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- There have been cases where the securities have been downgraded that also led to less returns.
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Quick Fact

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Indexation

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It refers to the mechanism wherein the gains are adjusted against the rate of inflation to derive the net taxable gains from the schemes.

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Source: The Hindu

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