

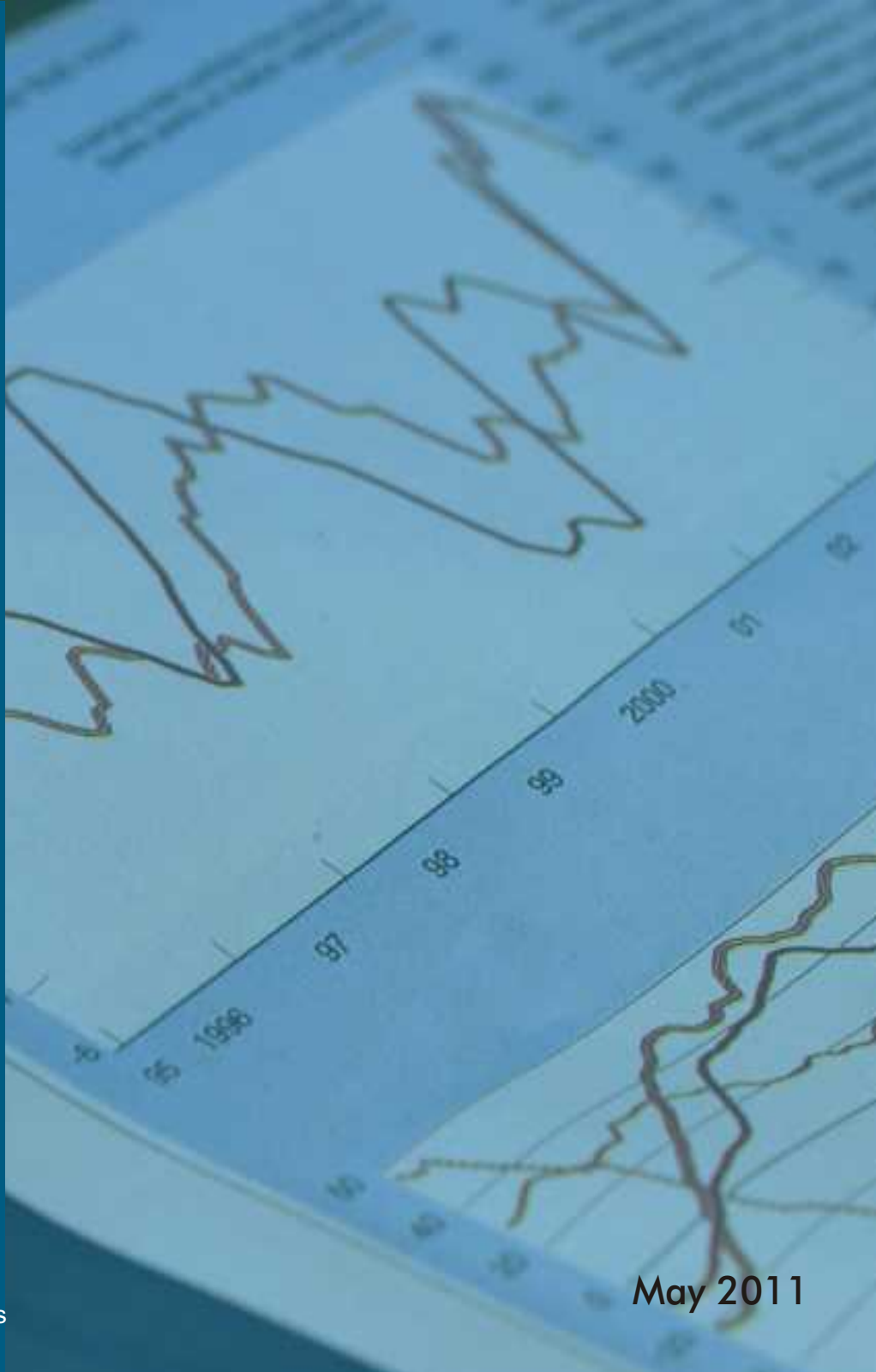
Fund Insights

Liquid funds - an
alternative to savings
bank deposits

Satish Prabhu
Senior Manager - CRISIL FundServices

Akshat Hebbar
Executive Analyst - CRISIL FundServices

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Liquid funds - an alternative to savings bank deposits

Provides higher returns with a reasonable degree of safety

Retail investors have ignored a more remunerative option, viz liquid funds, and continued to park their surplus cash in savings bank accounts. Not only does the former offer higher post-tax returns, it also offers a reasonable degree of safety in terms of the principal invested. Moreover, these investments are highly liquid. Most retail investors, though, are either unaware of this or averse to liquid funds owing to concerns of probable capital erosion. According to the Association of Mutual Funds in India (AMFI), of the Rs 2.22 trillion assets under management (AUM) in liquid funds as on April 30, 2011, retail investors constituted less than 1% share while the rest was held by high net-worth individuals, corporates, banks and financial institutions. On the other hand, the size of savings bank deposits has continued to grow despite yielding only a nominal rate of return. The quantum of money in savings bank accounts in scheduled commercial banks was Rs 11.36 trillion¹ as on March 31, 2010, as a majority of Indians continue to view savings bank deposits as the safest option for parking liquid cash.

Liquid funds vs similar options available from banks

Liquid funds are mutual fund schemes where the primary objective is to invest in debt instruments with maturities of less than 91 days, generating optimal returns while maintaining safety and high liquidity. Liquid funds primarily invest in money market instruments such as certificates of deposits (CDs), commercial papers (CPs) and government treasury bills. Such a portfolio helps liquid funds provide high liquidity to investors. Accordingly, redemption requests are processed within 24 hours.

Table 1: Comparison of savings deposit, fixed deposit and liquid funds

	Savings deposit	Fixed deposit	Liquid funds
Liquidity	High	Medium	High
Annualised returns	Up to 4% ²	5.0% - 10.0%*	5.37% - 7.14%**
Minimum lock-in	No	Yes	1 day
Principal guarantee	Government-backed guarantee of up to Rs 0.1 million	Government-backed guarantee of up to Rs 0.1 million	No guarantee
Safety (to the principal amount)	High	High	Medium
Penalty (on early withdrawals)	No	Yes ³	No
Availability of cheque facility	Yes	No	No
Tax	0-30% [^]	0-30% [^]	25% ^{^^} in dividend option 0-30% [^] in growth option (<1 year investment) 10 or 20% [@] in growth option (>1 year investment)

* The interest rate varies with the tenor of the deposit

**1-year returns as on April 30, 2011 of CRISIL Mutual Fund Ranked schemes (for quarter ended March 31, 2011)

[^] plus 3% cess

^{^^} plus 5% surcharge and 3% cess

[@] 10% without indexation or 20% with indexation whichever is lower plus 3% cess

¹ RBI data

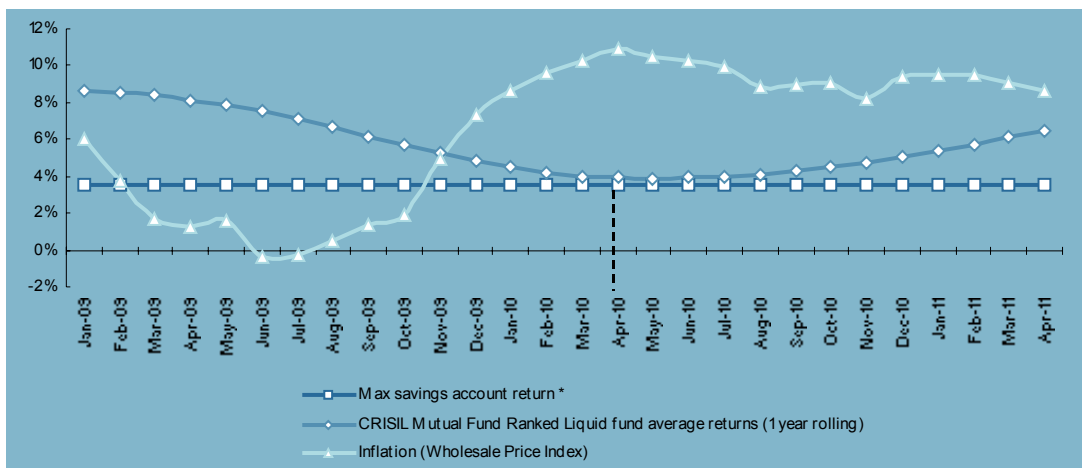
² Earlier banks calculated interest on savings account at 3.5% p.a. on the lowest available balance between the 11th of the month till the end of the month. From April 1, 2010, interest is calculated on the available balance on a daily basis. This way, savings account holders earn interest on every rupee deposited. Further, from May 2011, the interest rate has been increased to 4%

³ In the case of most banks, the depositor would receive 1% less for any premature withdrawal

Liquid funds, although not backed by any principal guarantee, are relatively safe instruments as the portfolios of liquid funds mostly comprise 'P1+' rated CPs and CDs (highest rating for these types of securities) with a maximum maturity of 91 days. CRISIL's rating of 'P1+f' signifies "very strong" protection against losses from credit defaults.

However, the marginally higher risk in liquid funds as compared to a savings deposit is compensated by superior returns of liquid funds. CRISIL has analysed the performance of liquid funds vis-à-vis returns offered by a savings deposit (see Chart 1). During the period under review, returns from liquid funds (1-year rolling returns) were always higher than the interest offered on a savings bank account. Moreover, during periods of rising inflation, returns from a liquid fund were typically higher, thereby reducing the effect of inflation. This was not so in the case of a savings bank deposit where the returns were constant. Therefore, during a high inflation cycle, investors have been better off investing in liquid funds.

Chart 1 - Returns offered by liquid funds vs savings bank deposits



* From April 1, 2010, interest is calculated on the available balance on a daily basis. Prior to this, banks calculated interest on savings account at 3.5% p.a. on the lowest available balance between the 11th of the month till the end of the month.

Source: Ministry of Commerce and Industry for Inflation rates, RBI for savings bank deposit rate, CRISIL Mutual Fund database for liquid fund returns

The tax advantage

There are two options of investing in a liquid fund: i) growth option and ii) dividend option. The difference between the two options is that there are intermittent cash flows by way of dividends in the case of the latter, while the growth option is cumulative in nature. The dividend option also has various dividend frequencies, viz daily, weekly, fortnightly, monthly, quarterly and half yearly.

In the case of growth option, returns from liquid funds would attract short term capital gains if redeemed within a year (as per the investor's income tax bracket) and long term capital gains if redeemed after a year (10% without indexation and 20% with indexation plus cess).

In the case of a dividend option, although dividends are tax-free in the hands of the investor, there is a dividend distribution tax (DDT)⁴ which is paid by the mutual fund house before the dividend is

⁴ As per Union Budget 2011-12, the DDT rate in the case of institutional investors has been raised to 30% from 25% (plus 5% surcharge and 3% cess). This would take effect from June 1, 2011. There would, however, be no impact on retail investors who would continue to be charged DDT of 25% (plus 5% surcharge and 3% cess).

distributed to unit holders. Investors who are not in need of frequent cash flows can opt for the 'dividend reinvestment plan' so that these cash flows are reinvested into the same liquid fund.

Post tax, liquid funds yield better returns vis-à-vis savings deposits, where the interest earned on the latter would be taxed based on an individual's tax slab. Investment in a fixed deposit would also attract tax on returns as per the investor's tax-bracket (maximum of 30% plus cess).

Table 2: 1-year returns across investment types (as of March 31, 2011)

Investment type	Investment amount (Rs)	Indicative yield	Pre-tax returns (Rs)	Tax rate (highest)	Post-tax returns (Rs)	Post tax yield
Savings account	100,000	4.00%	4,000	30.9000%	2,764	2.7640%
Fixed deposits		7.75%*	7,750	30.9000%	5,355	5.3553%
Liquid fund – Dividend		6.34%^	6,340	27.0375%	4,626	4.6258%
Liquid fund – Growth		6.34%^	6,340	20.6000%**	6,340@	6.3400%

*State Bank of India fixed deposit rate for 181 days to less than 1 year

^ 1-year returns of CRISIL Fund Rank 1 Liquid Funds

** Assuming an investment of 1 year and 1 day

@ Indexation benefits have resulted in nil tax

As illustrated in Table 2, an investor who falls under the highest tax bracket would have earned 1-year return of 6.34% (post tax) if invested in CRISIL Fund Rank 1 Liquid Funds (growth option) as against 5.36% through 1-year fixed deposit and 2.8% from savings bank account.

Choosing a liquid fund

Choosing an appropriate liquid fund can be a challenge as there are more than 40 funds offered by various fund houses. Further, most liquid funds have very little differentiation. However, the variation in returns between the best performing and worst performing scheme is almost 2% on an annualised basis. Hence, it is important for investors to assess the various schemes before investing. Some factors such as fund house and scheme vintage, overall AUM, consistent performance over a longer period and comparison with appropriate benchmark can be looked at for fund selection. A more informed investor can also consider the fund manager's history, number of times the fund has given returns below the risk-free rate, and portfolio attributes such as instruments, company concentration and credit quality to understand the risks in the scheme in greater detail.

Amount invested in a savings account vs liquid fund for 5 years - an Illustration

If an individual had Rs 100,000 to invest as on April 1, 2006, which he wanted to keep handy and available at short notice, the same could be maintained either in a savings bank account or parked in a liquid fund. Let us see how the amount would have grown over a 5-year period.

	Liquid Fund (Growth Option)	Savings Account
Amount invested on April 1, 2006	100,000	100,000
Interest / Gain (Post tax)	38,082	12,865
Post Tax Amount as on March 31, 2011	138,082	112,865
Annualised post tax return on investment	6.67%*	2.45%

* On CRISIL Fund Rank 1 index for liquid funds with indexation benefit

Alternatively, investors, especially retail, may refer to CRISIL's quarterly Mutual Fund Rankings which covers 453 schemes across 22 categories, including 22 liquid funds. CRISIL's quarterly Mutual Fund Ranking⁵ uses various net asset value and portfolio attributes to rank liquid funds. These parameters include:

- AUM
- Returns
- Volatility (a measure of risk)
- Tenor of funds
- Company concentration
- Liquidity
- Asset quality

CRISIL's methodology is time-tested and robust as it not only looks at returns (which may be similar across liquid funds) but also at the portfolio attributes to judge the safety and quality of the fund. Top schemes in this category have consistently excelled over longer time frames.

Increasing retail investor participation in liquid funds

It is important to understand why retail investors are ignoring liquid funds. One of the primary reasons is awareness. Today, even the salaried class is unaware of the benefits of liquid funds. Further, most fund houses do not have a presence in smaller cities and towns. Also, distributors are not interested in selling these schemes due to the low commissions. Hence, some steps which can be implemented by the mutual funds to increase retail investor participation in liquid funds include:

- Informing and educating salaried individuals to make regular monthly transfers to liquid funds for enhanced returns.
- Holding investor education programmes, especially in the premises of large employers (both PSU and private sector), to communicate the advantages of liquid funds.
- Educate investors to effectively use systematic transfer plans (STPs) or switch options to make investments in equity or debt funds from their liquid funds. For bank-run mutual funds, investors may transfer a regular surplus to a liquid fund account, which in turn would transfer money into systematic investment plans (SIPs).

Liquid funds are very popular in the US as they have cheque writing facilities similar to a bank account; this has been a key factor behind the rapid growth of liquid funds in the country. Given the cheque writing facility, many corporations could credit salaries directly to the liquid fund accounts of their employees. In India, AMFI has also requested the Reserve Bank of India to permit liquid and money market mutual funds to issue cheque books. If this is accepted, it could revolutionise the mutual fund industry.

Conclusion

Liquid fund is an alternate investment avenue for individuals to park their short term surplus funds. While bank deposits (fixed and savings) are easier to access and offer some degree of principal protection, the higher yield combined with the liquidity and taxation benefits make liquid funds an attractive option.

However, liquid funds are not risk-free, and an investor must carry out basic checks before investing. Further, investors must spread their savings across fixed deposits, savings bank account and liquid funds, thereby enjoying the benefits each of these avenues have to offer.

⁵ Available on www.crisil.com

About CRISIL FundServices

CRISIL FundServices is India's leading provider of fund evaluation and research to the Indian Mutual Fund industry. Widely acknowledged as the industry standard, CRISIL FundServices is the official provider of valuation tools and market benchmarks. Through its innovative analytics, benchmarks and analytical tools, CRISIL FundServices has played a significant role in shaping investor confidence and facilitating the introduction of best practices in the Mutual Fund industry.

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Mumbai

CRISIL House
Central Avenue
Hiranandani Business Park
Powai, Mumbai - 400 076, India.
Phone +91 (22) 3342 8035/26
Fax +91 (22) 3342 8088

New Delhi

The Mira
G-1 (FF), 1st Floor, Plot No. 1&2
Ishwar Nagar, Near Okhla Crossing
New Delhi - 110 065, India.
Phone +91 (11) 4250 5100
2693 0117-21
Fax +91 (11) 2684 2212/13

Chennai

Mezzanine Floor, Thappar House
43 / 44, Montieth Road
Egmore
Chennai - 600 008, India.
Phone +91 (44) 2854 6205/06, 2854 6093
Fax +91 (44) 2854 7531

Bengaluru

W-101, Sunrise Chambers
22, Ulsoor Road
Bengaluru - 560 042, India.
Phone +91 (80) 4244 5309
Fax +91 (80) 2559 4801

Kolkata

'Horizon', Block 'B', 4th floor
57 Chowringhee Road
Kolkata - 700 071, India.
Phone +91 (33) 2283 0595
Fax +91 (33) 2283 0597

For further details or more information,
please contact:

Client Servicing
CRISIL House
Central Avenue
Hiranandani Business Park
Powai, Mumbai - 400 076, India.
Phone +91 (22) 3342 3561/ 62
Fax +91 (22) 3342 3501
E-mail: mfresearch@crisil.com