Why Debt Funds are better than Fixed Deposits?

- Fixed deposits have been one of the traditional sources of investment. The interest earned on fixed deposits is added to the total income under the section 'Income from other Sources' and then taxed at applicable slabs. Due to this, investors investing in fixed deposits end up earning lower post-tax returns. While for debt funds capital gain tax is applicable for which indexation has to be applied. For applying indexation, cost inflation index is used. Indexation in simple words means returns are adjusted for inflation by taking into account cost inflation index. If indexation advantage is taken into consideration then the difference between returns of fixed deposit and debt funds is significant.

- A penalty charge is levied on fixed deposits for premature withdrawal which is not the case with debt funds. On premature withdrawal of FDs, the full amount of that particular FD has to be withdrawn. While for debt funds, the investors have the option to choose how much amount or units they seek to withdraw. One also has an option to schedule and withdraw certain amount periodically.
- A fixed deposit does not offer protection against inflation. If the inflation rises significantly during the tenure of a fixed deposit, the advantage of such higher inflation is not available for fixed deposits since indexation benefit is not applicable to FDs. This makes debt funds more beneficial for the long term.
- If invested in debt funds for more than three years, the returns are taxed with 20.6% with indexation. In case of high inflation, the tax on debt funds is reduced to minimal or in some cases it comes to zero due to indexation benefit. In case, the investment is made for a period of three years but it constitutes four financial years then indexation benefit for four years is applicable for a holding period of three years. Due to this, the tax payable is NIL in some cases.

- People have a perception that fixed deposits in banks are safe. The FDs are insured by the banks with Deposit Insurance and Credit Guarantee Corporation (DICGC) up to a maximum limit of Rs. 1 lakh only for both principal and interest. Despite of having crores of rupees in FDs with the banks, if something worse happens to the bank, the investor will only get back a maximum amount of Rs.1 lakh only.
- Let us take a look at an example of how better returns can be earned through debt funds:

  Note: Tax on debt funds is charged @ 20.6% with indexation. Indexation means adjusting the inflation with investment. Benefit of indexation and Capital Gains is not applicable to fixed deposits. Market Value is calculated by compounding.

	Fixed Deposit
A. Investment (Rs.)	1,000
B. Return (%)	9 p.a.
C. Inflation (%)	8 p.a.
D. Investment Period	3 yrs
E. Cost of Purchase (Rs.)	1,000
F. Market Value (end of three years) (Rs.) **[A+9%+9%+9%]**	1,295
G. Income Earned (Rs.) **[F – A]**	295
H. Tax @ 30% **[G x 30%]**	88.5
I. Post-Tax Gains (Rs.) **[F-H]**	**1,206.5**
J. Tax @ 20% **[G x 20%]**	59
K. Post-Tax Gains (Rs.) **[F-J]**	**1,236**
L. Tax @ 5% **[G x 5%]**	14.8
M. Post-Tax Gains (Rs.) **[F-L]**	**1,280.2**

	Debt Funds
A. Investment (Rs.)	1,000
B. Return (%)	9 p.a.
C. Inflation (%)	8 p.a.
D. Investment Period	3 yrs
E. Cost of Purchase (Rs.) **[A+8%+8%+8%]**	1,259.7
F. Market Value (end of three years) (Rs.) **[A+9%+9%+9%]**	1,295
G. Capital Gains (Rs.) **[F – A]**	295
H. Tax @ 20% **[(F – E) x 20%]**	7.1
I. Post-Tax Gains (Rs.) **[F-H]**	**1,287.9**

By investing in FD, those investors who fall in 30% tax bracket will take home Rs.1,206.5, those in 20% tax bracket - Rs.1,236 and people who fall in 5% tax bracket will earn Rs.1,280.2 only. By the table above it can be clearly seen that investors investing in debt funds will take home Rs.1,287.9 as compared to fixed deposits.

- Many investors make a common mistake of comparing past returns from debt funds with current FD returns. Ideally, past returns of debt funds should be compared with past returns from FDs during that period.
