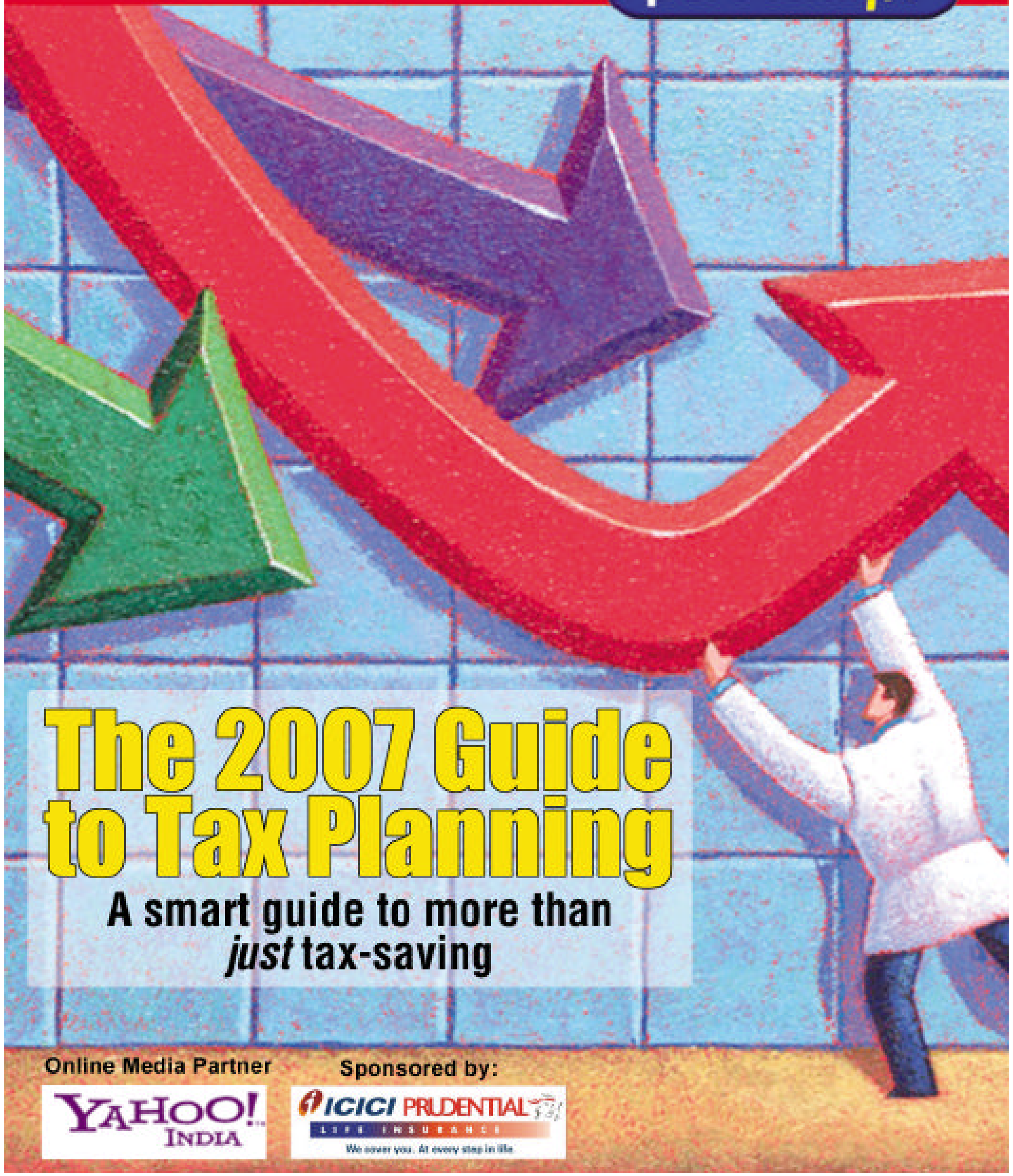
Money Simplified

VOLUME XXVII NOVEMBER 2006

personalfn



The 2007 Guide to Tax Planning

A smart guide to more than *just* tax-saving

PREFACE

Money Simplified

The 2007 Guide to Tax Planning

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This year, in keeping with convention, don't invest *just* to save tax. Plan your tax-saving investments in a manner that they fit in well with your long-term financial goals. This is our advice to you.

In this issue of the Money Simplified, we deal at length with how you should look at tax-planning as part of your overall financial planning process and not just some ad hoc investment process. We offer a comparative analysis of various investment destinations which offer a tax benefit (at the time of investment). Finally, we suggest an indicative allocation for people at various stages in their life cycle. We are certain you will benefit from the same.

The Money Simplified recently released its 25th issue. We had our launch in August 2002; since then we have come a long way. Presently we have about 140,000 registered subscribers who have downloaded a total of about 575,000 copies of the Money Simplified! That's not all; the feedback we receive reveals that on an average, a Money Simplified subscriber forwards the guide to about 3 contacts. Simple math suggests that there are at least 2 million copies of the Money Simplified in circulation! Thank you to all our subscribers for making this happen!

We remain committed to the cause of investor education and take this opportunity to assure each of our subscribers, that we will spare no effort in achieving our goal - investor empowerment.

Happy investing!

Team Personal*fn*
15th November, 2006

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Asset allocation for tax-saving investments

Investing to save tax is something that most of us do as a habit. But what we do not realise is that many a times we are investing to "only" save tax, when a lot more can be accomplished with the same amount of money. Over here we discuss how this is possible.

At the start of your career, when you are still 'care free' and the near-term needs are limited, you should consider taking on maximum risk to grow your money. Every Rupee you invest wisely today is worth more than the Rupee you invest tomorrow. So when you are planning your taxes, allocate a higher portion to risky assets like tax-saving mutual funds, which invest all their money in the stock markets. Of course, you need to take care that you select the right funds. This is because the fund management styles of various tax-saving funds are different. Some are aggressively managed, others are more conservative. So, you need to pick up a fund that suits you the best. Also, remember, there is a lock-in of 3 years.

With respect to the other avenues, the Employees' Provident Fund (EPF) is something that is compulsory for salaried individuals, so there is no option there. You can consider putting in some money in the Public Provident Fund (PPF), where again you need to be aware that the return offered is not fixed but is subject to annual revision. Also, the scheme has a 15-Yr duration; so if you need this money say 5 years from now, the PPF may not be the best option.

The most important instrument that you should consider adding to your portfolio is life insurance. At a young age, insurance is extremely cheap. The insurance we are referring to is 'pure risk' insurance or term insurance as it is called. These policies are generally not very popular as the payouts are made only in case the policyholder passes away. If he lives through the tenure of the policy, there are no payouts. While most people consider this to be a bad investment, in our view, it is the best.

Term insurance is really cheap (a person in good health aged 30 years, can buy a term insurance plan from a reputed insurer of Rs 1 m with a 30-Yr tenure, for an annual premium of just Rs 3,430). As is evident term insurance is really cheap. If you were to however buy a savings based policy (which has a payout at the end of the maturity of the policy), the comparative premium would be Rs 29, 820 per annum!

When buying term insurance, go in for the maximum tenure. This will ensure that your dependants are adequately provided for over a considerably longer tenure, at a relatively low cost.

You must own the property you live in - the earlier, the better. Alternatively, you should own a property which will ultimately serve as your residence. It's a necessity. How you can save tax while satisfying this need is by part -financing the property by taking a home loan. The home loan repayment, every month,

consists of two portions - the interest payment and the principal repayment. Both the interest component (upto Rs 150,000 per year) and principal repayment (upto Rs 100,000 per year subject to an overall limit of Rs 100,000 under Section 80C) carry significant tax benefits. If you are in the highest tax bracket, and have taken a loan at 10% per annum, your effective cost of the loan will be less than 7% per annum!

So, at the start of your career, try and make a portfolio that will not only save you tax but also contribute significantly towards creating wealth in the future; and of course, the term insurance will provide for your family in case anything were to happen to you.

Recommended Assest Allocation

Age (Years)	Life insurance premium	EPF	PPF / NSC	ELSS	Total
< 30	10,000	20,000	20,000	50,000	100,000
30 - 45	10,000	30,000	25,000	35,000	100,000
45 - 55	10,000	35,000	30,000	25,000	100,000
> 55	10,000	-	65,000	25,000	100,000

All allocations are in Rupees

The table above lists an indicative asset-allocation plan for individuals across various age groups. As can be seen, as you grow older, the allocation has to change in favour of the low-risk instruments. However, it should be understood that the table is only indicative; at Personalfn we have met clients who are in the higher age brackets but have a large appetite for risk (as their near term needs are provided for). Hence you must involve your advisor in the tax-planning exercise.

Investing to save tax is something that most of us consider easy-to-do. Well, in a way it is. Any investor can invest to save "only" tax. But what will make you a smart investor is the fact that you not only saved tax, but also achieved other financial goals that you had set for yourself.

Here are some do's and don'ts that will guide you in preparing your asset allocation for tax-saving instruments -

1. Do not follow conventional methods of saving tax blindly; in present times there are a lot more options available which can serve your purpose better.

2. Do not invest in an ad hoc manner; work out an asset allocation that is best suited to not only saving tax but also helping you realise your other financial goals

3. Do employ the services of a financial planner, who is both competent and credible; financial planners can help you put your entire asset allocation in perspective and also help you structure the same in a manner that is best suited to meeting your financial goals

4. Do spend time when deciding to invest your money, be it for tax-saving or any other purpose.

What Section 80C offers

For most, the tax-planning exercise is a dreary and unwarranted activity to be conducted on an annual basis. However, there is another important aspect to tax-planning, which is often overlooked. Tax-planning can double up as a great way to save for the future. Considering that very few individuals actually save in a disciplined manner, tax-planning can be a mode for accomplishing long-term objectives like retirement. The key lies in conducting the tax-planning exercise in the right manner. And thankfully for investors, the tax laws actually aid them in doing so.

Investing for the purpose of tax-planning is no different from making investments in the normal course i.e. all the principles of investing are equally relevant while conducting the tax-planning exercise. For example, investors should invest in line with their risk profile, and the portfolio should be a well-diversified one, among others. Sadly the earlier tax regime (under Section 88), was restrictive in nature and prevented investors from doing so. Sectoral caps existed on various "eligible" investment avenues; these in turn determined what the investor's tax-planning portfolio would look like. The Section 88 regime had a marked bias in favour of conventional "assured return" investment avenues.

Enter Section 80C

The introduction of Section 80C in the Finance Bill 2005 should be credited for bringing about a sea-change in the method of conducting the tax-planning exercise. Section 80C lists a wide range of avenues and investments that are eligible for deduction from gross total income. The upper limit for deduction under Section 80C has been set at Rs 100,000. However, more importantly, within the earmarked avenues, investors are free to invest in an unrestricted manner i.e. the caps on various avenues have been done away with.

Hence an investor who has an appetite for high-risk investment avenues can exhaust his Rs 100,000 limit by investing in tax-saving mutual funds. On the other hand, a risk-averse investor can invest in assured return schemes like Public Provident Fund (PPF), National Savings Certificate (NSC) and tax-saving fixed deposits.

Table 1

Tax Rate	Tax Saved (Rs)
10%	10,200
20%	20,400
30%	30,600

Education cess charged at 2.00% has been considered while computing tax liability saved.

The eligible avenues under Section 80C are,

1. Payment of life insurance premium
2. Contribution to provident fund
3. Repayment of principal amount on housing loan
4. Payment of tuition fees
5. Investments in PPF
6. Investments in NSC
7. Investments in tax-saving FDs
8. Investments in tax-saving funds (ELSS)
9. Investments in Infrastructure Bonds

Section 80C: Reducing tax burden

Investors, who contribute towards earmarked Section 80C investments, stand to benefit by way of a reduced tax burden. Table 1 lists the tax liability saved, assuming that an investment of the maximum (Rs 100,000) limit is made under Section 80C, across various tax brackets.

How tax-planning can help

As mentioned earlier, the tax-planning exercise can go a long way in helping investors save for the future. Firstly, since investing for the purpose of tax-planning is an annual exercise, it imparts a degree of discipline to the process. Secondly, the amounts involved (upper limit of Rs 100,000) tend to be quite substantial. Over longer time frames, these investments can have a substantial impact on investors' finances. An example should help us understand this better. Suppose an individual invests Rs 100,000 every year in the designated Section 80C avenues; we shall assume that the investments yield a return of 8.00% per annum. At the end of 15 years, his investment portfolio would be worth Rs 2,715,200.

What should investors do?

Given that Section 80C has provided the impetus for conducting the tax-planning exercise in the right manner, the onus now shifts onto the investors. Investors need to ensure that they give their tax-planning activity sufficient time and attention. They must engage the services of a qualified investment advisor, draw up the necessary plans and then invest in line with the same. The financial implications involved should serve as incentive enough to ensure that tax-planning isn't treated like just another mundane exercise.

Snapshot: Tax-saving investment avenues

Particulars	PPF	NSC	ELSS	Infrastructure Bonds	Tax-saving FDs
Tenure (years)	15	6	3	3	5
Min. investment (Rs)	500	100	500	5,000	100
Max. investment (Rs)	70,000	100,000	100,000	100,000	100,000
Safety/Rating	Highest	Highest	High Risk	AA/AAA**	Highest
Return - CAGR (%)	8.00	8.00	12.00 - 15.00*	5.50 - 6.00^	7.50 - 8.00
Interest frequency	Compounded annually	Compounded half yearly	No assured dividends/returns	Options available	Options available
Taxation of interest	Tax free	Taxable	Dividend & capital gains tax free	Taxable	Taxable

** Approximate returns. ELSS is a market-linked investment avenue and returns are not assured.*
***AA/AAA are credit ratings indicating the degree of safety regarding timely payment of interest and principal, with AAA being the highest rating.*
^ Indicative returns

Tax-saving funds: Rewarding the aggressive investor

While the tax-saving investments landscape is dotted mainly by bonds and small saving schemes, the saving grace for the risk-taking taxpayer is the tax-saving fund, also known as Equity-linked Saving Scheme (ELSS). That is why it is important for investor to make the most of this limited opportunity.

Under existing laws, Section 80C allows investors to invest upto Rs 100,000 in tax-saving funds. Not so long ago (2 years to be exact), this limit was a mere Rs 10,000 under a different Section (Section 88, which is now done away with), which gave a tax rebate. So for the risk-taking investor the revised limit is nothing short of a boon.

Tax-saving funds become an obvious choice for the risk-taking investor for the following reasons.

1) Tax-saving funds are the only pure investment avenue linked to equity markets. Apart from ULIPs (unit-linked insurance plans), which have an insurance element, tax-saving funds are your only ticket to stock markets.

2) Tax-saving funds have a 3-Yr lock-in. At first, this may sound like a letdown, but remember being in equity markets for less than that may prove counter-productive. Equities tend to perform well over the long term (at least 3 years in our view) and investors must be willing to wait that long. The 3-Yr lock-in also enables fund managers to take a long-term view on their investments.

Over the years some tax-saving funds have caught the discerning eye of the Personalfn Research Team. These tax-saving funds had the same old traits in them that we prefer to see in a well-managed equity fund - credible sponsors, solid investment philosophy, team-based investment approach, steady performance across market cycles (particularly the downturns) and above-average performance across all parameters related to NAV performance and risk (Standard Deviation and Sharpe Ratio).

We short-listed 3 well-established tax-saving funds that we like; in addition to them, we have also selected 2 more tax-saving funds that have appeared on our radar and are likely to do well going forward.

1) HDFC Long Term Advantage

Profile

Launched in January 2001, the fund began its innings as HDFC Tax Plan 2000. It is the original tax fund from HDFC Mutual Fund, one of the more respectable names in the industry, which pursues a team-based investment approach guided by well-defined processes. Its sibling - HDFC Tax Saver (covered later in the article) is from Zurich India Mutual Fund, a fund house HDFC Mutual Fund took over in 2003. In its relatively short history (other tax-saving funds in our preferred list have a decade-long existence), HDFC Long Term Advantage (HLTA) has carved a niche for itself as a well-managed tax-saving fund pursuing the value style investment strategy.

Over the last 12 months, HLTA's NAV (net asset value) has appreciated by 39.3%. Over 3-Yr and 5-Yr, its NAV has grown by 54.1% CAGR and 57.5% CAGR respectively.

Is this fund for you?
HLTA is managed by Mr. Tushar Pradhan, one of the more successful practioners of the value style of mutual fund investing. His team also manages - HDFC Capital Builder, another well-established value style fund. Value investing involves selecting well-managed companies that are trading at a discount to their fair value. The fund manager is invested in the company till such a time that it attains its fair value. This is a relatively conservative investment strategy as opposed to the growth style of investing, wherein the fund manager invests in companies that are already fairly valued in the hope that the stock price will rise even further.

HLTA has established an impressive track record by pursuing the relatively low-risk value style. It scouts for value picks across large caps and mid caps. It is usually invested upto 90% in equities. HLTA has a well-diversified stock portfolio - 37.6% of net assets in top stocks, which fares well against our criterion of 40% for diversified equity funds. However, sectorally it takes aggressive investment decisions. To its credit, the fund hasn't let that affect its volatility; it has the best performance on that front (Standard Deviation 5.65%) in our sample. Equally impressive is the fund's ability to generate above-average return per unit of risk borne (Sharpe Ratio 0.49).

In our view, tax-saving investors with moderate-high risk appetite must consider adding the fund to their portfolios. The fund's admirable track record on all critical parameters (related to NAV performance as well as risk) makes it an obvious choice for investors.

2) HDFC TaxSaver

Profile
Launched in December 1995, HDFC Tax Saver (HTS) is one of the best tax-saving funds in the country in terms of consistency. It is among the few tax-saving funds to complete a decade in business and over this time its performance has shown very little cause for complain. Earlier, Zurich India Tax Saver Fund, the fund was re-christened with the HDFC tag, subsequent to its take over by HDFC Mutual Fund. Unlike its sibling - HDFC Long Term Advantage Fund (covered earlier), HTS is managed aggressively in line with the growth style of investing.

Over the last 12 months, HTS's NAV (net asset value) has appreciated by 51.7%. Over 3-Yr and 5-Yr, its NAV has grown by 61.3% CAGR and 56.0% CAGR respectively.

Is this fund for you?
HTS pursues the aggressive growth style of investing. This involves investing in well-managed companies that are fully/fairly valued in the hope that they are likely to do even better going forward.

For a large part of its existence, the fund was managed by Mr. Prashant Jain, one of the most credible names in the fund management business, either directly (in the capacity of a fund manager) or indirectly; at present he manages it indirectly as the CIO (Chief Investment Officer) of HDFC Mutual Fund.

Over the years HTS, like its sibling HDFC Equity Fund (an open-ended diversified equity fund) has developed quite a knack for making relatively correct investment calls (like selling technology stocks well before the meltdown in February 2000). This has helped the fund tide over volatility despite pursuing a relatively aggressive investment strategy. Its aggressive style is particularly evident in its top 10 holdings (49.0% of net assets), which is a lot more than the 40% we like to see in equity funds.

However, that hasn't ruffled the fund f rom pitching in top-notch performances on all the risk parameters. It terms of volatility, the fund's Standard Deviation (6.85%) is among the best in its peer group. Likewise, it ranks high on the risk-adjusted return parameter (Sharpe Ratio 0.58%).

In our view, investors with a high risk appetite must consider investing in the fund for its admirable track record across parameters.

3) Franklin India Taxshield

Profile
Franklin India Taxshield Fund (FTF) was launched in 1999 by Pioneer ITI Mutual Fund, a fund house that got taken over by Franklin Templeton Mutual Fund in 2002. To that end, it shares the same pedigree as its more popular siblings - Franklin Bluechip Fund and Franklin Prima Fund. It also shares the same fund management resource in the form of Mr. Siva Subramanian and Mr. R Sukumar, two very credible fund managers.

Over the last 12 months, FTF's NAV (net asset value) has appreciated by 50.4%. Over 3-Yr and 5-Yr, its NAV has grown by 45.3% CAGR and 45.3% CAGR respectively.

Is this fund for you?
FTF began with a predominantly large cap investment strategy. However, it diversified across mid caps when it spotted opportunities in that segment. For some time now that is how it has been managed - a predominantly large cap fund (usually at least 75% of net assets are in large caps) that does not shy away from investing in well-managed mid cap companies.

The fund is managed conservatively, it has a superior performance in restraining volatility (Standard Deviation 6.34%). However, its top 10 holdings (49.4% of net assets) are higher than what we expect from a diversified equity fund, which is about 40%. In terms of risk-adjusted returns, it fares reasonably well (Sharpe Ratio 0.45%).

In our view, FTF although not exactly a trailblazer, must be considered for investment for its predominantly large cap investment strategy, which infuses a degree of stability in its performance. It will appeal particularly to the investor with a moderate risk appetite. Also, the fund's investment team has enough credibility for the fund to warrant a place in the investor's portfolio.

In addition to the 3 funds short-listed, there are 2 other tax-saving funds that investors can consider for investing. While these funds don't have the kind of track record that we would like to see in a fund, they have enough going for them to make us sit up and take notice.

1) PruICICI Tax Plan

While PruICICI Tax Plan (PTP) has some history behind it (launched in 1999), it caught our eye when its performance improved dramatically when a change in the fund management team saw Mr. Nilesh Shah (another, very respected fund manager) take over as CIO (Chief Investment Officer). While the fund's performance has looked up only over the past couple of years, we believe that the processes guiding the fund's investment should see it perform well going forward. Given the fund's aggressive investment strategy (it made some smart, although aggressive, investments during the mid cap rally) we believe it will suit the investor with an appetite for high risk.

2) Fidelity Tax Saver

Fidelity Tax Saver (FTS) is a recent entrant (launched in February 2006) in the tax-saving segment. Although the fund is yet to spend time in the Indian stock markets to qualify as a must-have, the parent has established its credentials across various world markets. With superior processes and relevant experience in Indian (through its FII which has been in existence for over 10 years) and international markets, we believe FTS is well-placed to give investors an above-average return at relatively lower risk over the long-term.

Leading tax-saving funds

Tax-saving Funds	NAV (Rs)	Assets (Rs m)	Top 10 Stocks	3-Yr (%)	5-Yr (%)	SD (%)	SR (%)	Launch Date
Magnum Tax Gain	50.30	9,694	35.40	**74.1**	61.4	6.83	0.67	Mar-93
HDFC TaxSaver	**140.55**	**6,628**	**48.95**	**61.3**	**56.0**	**6.85**	**0.58**	**Dec-95**
Pru ICICI Tax Plan	91.27	5,472	41.50	**54.9**	56.0	8.31	0.46	Aug-99
HDFC LT Advantage	**87.71**	**5,335**	**37.58**	**54.1**	**57.5**	**5.65**	**0.49**	**Jan-01**
Sundaram Tax Saver	25.32	868	27.56	**50.3**	49.1	7.37	0.45	Nov-99
Birla Equity Plan	55.14	943	44.50	**47.9**	53.6	6.92	0.48	Feb-99
Principal Tax Savings	73.90	1,580	39.46	**47.6**	48.9	7.29	0.43	Mar-96
Franklin Tax Shield	**122.45**	**2,863**	**49.43**	**45.3**	**45.3**	**6.34**	**0.45**	**Apr-99**
Birla Tax Relief 96	185.41	271	51.11	**41.3**	44.5	7.07	0.40	Mar-96
Tata Tax Saving Fund	39.98	1,213	36.27	**40.8**	43.1	7.58	0.35	Mar-96
BSE Sensex				**38.5**	**34.2**			

Source: Credence Analytics. NAV data as on October 30, 2006. Growth over 1-Yr is on CAGR basis. SD - Standard Deviation. Net Assets as on September 30, 2006.

5 things to look at in a tax-saving fund

Tax-saving funds are a great way for risk-taking investors to invest their monies for the long-term and earn tax benefits on the side. However, selecting the right tax-saving fund is not so simple. There is a need, as with regular diversified equity funds, to evaluate tax-saving funds on critical parameters to ensure that you don't invest in the wrong scheme. Remember, all tax-saving funds offer a tax benefit, so there isn't much to choose from over that parameter, but not all tax-saving funds make great investments, so there is plenty of evaluation to be done before you short-list the right tax-saving funds.

We have formulated a 5-step strategy for every investor looking at investing in tax-saving funds.

1. Assess your risk profile

Since investing to save tax is no different than investing for retirement or for child's education, investors need to consider the important principles of investing while selecting tax-saving funds. That is why it is important for you to have your eye on your risk profile at all times. While, it is a given that a tax-saving fund investor has the requisite risk appetite, it still does not make his task any simple. The reason is that there are plenty of tax-saving funds out there that pursue varying investment styles. So you must find the one that best suits your own risk profile.

For instance, HDFC TaxSaver is an aggressively managed, growth style, tax-saving fund. Another fund from the same fund house - HDFC Long Term Advantage, is a value style fund and hence conservatively managed. As an investor you have to evaluate where you fit in - with the aggressive fund or the conservative one.

2. Evaluate the fund house

Since the fund house plays a vital role in the performance of every scheme, it is crucial for investors to identify the right fund house while choosing a tax-saving fund. The sponsors, their investment philosophy and the systems and processes rank as extremely critical parameters at Personalfn. In fact, our research on a mutual fund scheme begins with these parameters.

Put briefly, investors must avoid fund houses that are overly dependent on star fund managers. Because when a star fund manager leaves, he takes the performance with him. And given that tax-saving funds that have a 3-Yr lock-in, you can't even chase the star fund manager (we don't recommend it anyways). So it's important that you go for fund houses that are managed by teams. Teams are usually guided by well-documented processes and systems (like having investment caps on individuals stocks or sectors), which make individual fund managers dispensable. Over the long-term, it is best to be 'married' to a team than an individual.

Our research team has come across instances of both - fund houses run by teams as well as those run by star fund managers. Franklin Templeton Mutual Fund, HDFC Mutual Fund, DSP Merrill Lynch Mutual Fund are some of the fund houses that are by teams. SBI Mutual Fund (which owns the popular brand of Magnum funds) for a long time had a star fund manager that propelled the fund house to great heights. But even the fund house has realised the perils of relying too much on one individual; they are now setting up processes to de-risk an individual fund manager's departure.

3. Compare returns over 3-Yr period

Once you have a fix on the fund house with processes, your scanner must now shift to the tax-saving fund's performance. Too many investors are obsessed with short-term performance (1-month, 6-month, 1-year) while evaluating equity funds. Comparing returns over such short periods of time in an equity investment is unreasonable, even more so for tax-saving funds because of the mandatory 3-Yr lock-in period. Hence the 3-Yr period should be treated as the minimum time frame for evaluating the performance of a tax-saving fund (as also all other equity investments).

While evaluating performance, it is important to note how the fund has fared over varying time periods. Every equity fund has its day under the sun during a bull run; it's the bear phase that separates the experts from the punters. So your view on a tax-saving fund should not be based on its performance on the last rally, it should be dictated based on its performance on the last market downturn.

4. Compare performance on the risk parameters

The NAV performance is not the only parameter to be considered for evaluation in your quest for a well-managed tax-saving fund. Parameters like Standard Deviation and Sharpe Ratio must be given equal weightage. How often have we seen a diversified equity fund deliver a brilliant performance on the 'NAV return' parameter by sacrificing all the rules of prudent investing and making aggressive investments across stocks and sectors and apportioning an above-average allocation to high risk investments like mid cap stocks or technology stocks for instance.

Therefore it's important for investors to keep an eye on the risk that the fund has taken to deliver that high-voltage performance. Risk parameters like Standard Deviation and Sharpe Ratio are important indicators . Standard Deviation measures the degree of volatility that a fund exposes its investors to; similarly Sharpe Ratio is used to measure the returns delivered per unit of risk borne. Find out how the fund measures up on these parameters vis-à-vis its peers. The ideal combination for an equity/tax-saving fund is lower Standard Deviation (i.e. lower volatility) and higher Sharpe Ratio (i.e. higher return vis-à-vis the risk-free investment).

5. Select the right option
The 3-Yr lock-in makes tax-saving funds relatively illiquid. While all equity investments must be made with a 3-Yr investment time frame, with tax-saving funds, this is 'imposed' on the investor.

For investors who want to eke out some liquidity (over the lock-in period) from a tax-saving fund, there is the dividend option. Tax-saving funds like regular equity funds declare dividends (although this is not assured and depends mainly on the performance of the fund) at periodic intervals. Investors who want a cash flow (even if at infrequent intervals) can opt for the dividend option.

Investors not looking for a cash flow should opt for the growth option. Over the long- term it is best to be invested with this option as taking out money from your investment (by way of dividends) works against the principle of compounding.

Life Insurance: Get the right perspective!

Ever wondered why most of us end up paying insurance premiums in the last few months (January to March) of each financial year. Well, that's because, insurance polices are often bought during that time span i.e. when the tax-planning "season" is at its peak.

The trouble with such an approach is that tax-planning becomes the cornerstone for buying insurance and the "insurance" aspect is sidelined. Sure, tax-planning is an important factor (premiums paid towards life insurance policies are eligible for deduction under Section 80C of the Income Tax Act), however, it should never be the mainstay. While doing so, the individual could well land up with the wrong insurance policy.

The right approach to buying insurance is to evaluate one's insurance needs and then narrow down on the most appropriate policy type. Given that there are multiple players in the life insurance segment, choosing the right insurer is vital as well. For example, a term plan could make an apt fit for a financially well-placed individual, who has no insurance cover and doesn't expect the insurance policy to generate "returns". Simply put, a term plan is a pure risk cover plan without any maturity benefit. The next step would be to scan through the various term plan offerings and to select a term plan that best matches the insurance seeker's needs.

Another element which could put a spanner in the works is the insurance advisor. For instance in the case above, the insurance advisor is unlikely to recommend a term plan, since he generally makes the least earnings on it as compared to unit linked insurance plans and endowment plans. As a result, most advisors prefer to "peddle" the latter, which are big commission earners, irrespective of the client's needs or risk profile. Hence it is imperative to be associated with the right insurance advisor i.e. one who accords greater importance to the insurance seeker's needs over his own.

Buying insurance should never be a rushed affair either. In such a scenario, prospective insurance buyers often end up playing into the hands of their agents. The outcome - they land up with policies which are more beneficial (read big commission earners) to the insurance advisor. Hence it would pay to commence the insurance exercise, well before the tax-planning season kicks in.

In this article, we discuss the various options from the insurance segment that are available to insurance seekers and identify the key factors to be considered.

Term plans
Term plans offer pure risk cover and merit inclusion in most portfolios. In fact, a term plan should be the first insurance product that insurance seekers should opt for. Term plans represent the most economical form of insurance i.e. they

offer a high insurance cover at a relatively lower cost. This is because only mortality charges and administration expenses are covered in the premium amount; there is no savings element. Hence, if the insured were to survive the policy term, there will be no maturity benefits i.e. the policy holder will not receive any returns when the policy matures.

Unit linked insurance plans (ULIPs)

ULIPs merge market-linked investments and insurance into a single product. In line with their mandates, ULIPs invest in equity and/or debt instruments in varying proportions. With equity markets on a surge over the last few years, ULIPs have been sold rather aggressively. It should also be mentioned here that perhaps the most instances of mis-selling have also been reported in this segment.

The expense structure of ULIPs is unconventional; a large portion of the premium (as high as 40%) during the first couple of years is deducted towards expenses and the balance invested in line with the stated mandate. However, the expenses do even out over longer time frames. Studies conducted by Personalfn reveal that ULIPs work out to be more economical vis-à-vis comparable mutual funds over longer time horizons (like more than 15 years). Hence it is imperative that policy holders continue with policy for the entire tenure.

Another advantage ULIPs offer is the flexibility they afford to the policy holder. The policyholder can "manage" his corpus by maneuvering it across plans. For example, when equity markets are on the rise, he can shift a part of his corpus to a debt-oriented portfolio. Hence it would help to be associated with an expert and qualified insurance advisor who can help select the right ULIP and manage it.

Endowment plans

Traditionally, endowment plans ranked as the most popular option from the insurance segment. Endowment plans typically invest a major portion of their assets in government securities and corporate bonds; a smaller portion can also be held in equities. Endowment plans are geared to offer returns to policy holders on maturity. By virtue of the same, they are often perceived as investment avenues. Child plans and money back plans are variants of endowment plans. Although they might be structured uniquely (for example, they offer returns in installments during the policy's tenure), in essence, they are endowment plans.

Pension plans

For far too long, Rs 10,000 was a defining amount for pension plans. The reason being, that was the maximum contribution (premium paid) to a pension plan, eligible for deduction under Section 80CCC of the Income Tax Act. Yet again, a case of tax-planning scoring over insurance needs.

Finance Bill 2006 corrected this anomaly. The Section 80CCC limit on pension

plans was enhanced i.e. contributions upto Rs 100,000 towards premiums paid for pension plans are now eligible for deduction under Section 80C (of which Section 80CCC is a part). This should encourage individuals to conduct their retirement planning with the right perspective.

In conclusion, we reiterate our view that individuals must let their needs determine the insurance products in their portfolio. Each product has its unique set of characteristics and should find a place in the portfolio based solely on the same. Notwithstanding the importance of tax-planning, the same should be treated as secondary, where insurance is concerned.

Tax-planning: The assured return way!

Conventionally, assured return schemes like Public Provident Fund and National Savings Certificate dominated investors' tax-saving portfolios. Apart from the attractive returns they offered, another reason for this phenomenon was the lop-sided nature of tax rebates under Section 88 (now abolished). Investments of only upto Rs 10,000 in tax-saving funds (ELSS) were eligible for tax rebates; the balance sum (Rs 90,000) had to be invested in PPF, NSC and infrastructure bonds, or utilised towards avenues like payment of life insurance premium and repayment of home loan (principal component of the EMI), among others.

While assured return schemes are unlikely to match market-linked avenues like tax-saving funds on the returns front, they should nonetheless find place in the investor's tax-saving portfolio. The risk-averse investor should invest in assured return schemes by virtue of the fact that they match his risk profile. Conversely, for a risk-taking investor who is likely to invest predominantly in tax-saving funds, assured return schemes can add a degree of stability to the portfolio.

Also the gamut of assured return offerings under Section 80C stands enhanced, thanks to the introduction of tax-saving fixed deposits from banks. In this article, we profile the various options available to investors and draw up an investment strategy.

Tax-saving fixed deposits

Tax-saving fixed deposits were introduced in the Finance Bill 2006. Simply put, these are fixed deposits (FDs) from banks which are eligible for deduction under Section 80C. In line with the guidelines, tax-saving FDs have a minimum tenure of 5 years. Also premature encashment is not permitted i.e. the investor has to be invested for the entire tenure.

Presently banks offer tax-saving FDs which yield between 7.50%-8.00% per annum with interest being compounded quarterly. Senior citizens are offered a more attractive interest rate (0.50% higher than the normal coupon rate). In most cases, the minimum investment amount is as low as Rs 100, with the upper cap being set at Rs 100,000 per financial year. As is the case with most FDs, these investments are subject to TDS (tax deduction at source) as well.

Investors can align the maturity proceeds of their FDs with their future needs. Similarly, they can choose between the regular interest payout (available without compounding benefits) and cumulative options depending on their liquidity requirements.

Public Provident Fund (PPF)

For many investors, PPF has been the mainstay of the tax-planning exercise. And perhaps rightly so! With a 15-Yr investment time frame and tax-free returns (interest income is exempt under Section 10), the scheme merits inclusion in most portfolios but in the right allocation. At present contributions to PPF, which are eligible for deduction under Section 80C, earn a return of 8.00% per annum. Although the scheme offers assured returns, they aren't fixed in nature i.e. the interest rate is reviewed annually. Hence in a rising rate scenario, contributions to the PPF account could offer more attractive returns vis-à-vis during a softer interest rate regime.

The minimum and maximum investment amounts (per annum) have been pegged at Rs 500 and Rs 70,000 respectively. PPF scores poorly on the liquidity front. Withdrawals can be made from the PPF account after completion of 6 years from the end of the financial year in which the first deposit was made. Furthermore, the amount which can be withdrawn is determined using the balance in the PPF account during the earlier years. Investors should invest only that portion of their investible surplus that has been earmarked for long-term investments.

Given the 15-Yr investment horizon offered by PPF, the scheme can be ideal for accumulating a corpus to provide for needs like retirement and children's education, among others.

National Savings Certificate (NSC)

Unlike PPF, wherein investors are required to invest on an ongoing basis, investments in NSC are a one-time event. NSC offers a return of 8.00% per annum with a half-yearly compounding. Also the returns are both fixed and assured. Hence the investment is insulated from external conditions, unlike PPF. Investments in NSC qualify for Section 80C benefits; the minimum investment amount is Rs 100, while the maximum is Rs 100,000 per annum. Also interest accrued on NSC is eligible for a Section 80C deduction for a 5-Yr period. Interest earnings from NSC are fully taxable.

NSC doesn't rank too favourably on the liquidity front. Premature encashment of investments is only permitted under specific circumstances such as death of the holder(s), forfeiture by the pledgee or under court's order.

Like tax-saving FDs, NSC is suited for investors who wish to make lumpsum investments.

The trade-off

Powered by tax-free returns, PPF comfortably scores over NSC and tax-saving FDs. Given that both tax-saving FDs and NSC are comparable investment avenues, returns and liquidity can be used as determining factors to choose between the two.

Tax-saving FDs hold the edge, thanks to the lower investment horizon (5 years vis-à-vis 6 years for NSC) and the marginally higher returns. However investments in NSC score in terms of the Section 80C benefit on the interest income.

What should investors do?
A PPF account should form a part of the tax-saving portfolio. Critics might point out that the EET (exempt-exempt-taxed) method of taxation, if implemented, could dent the returns offered by PPF. However even in such a scenario, the proposition offered by PPF i.e. forced savings (contributions must be made annually to keep the account active) and investment horizon (to meet long-term objectives like retirement), will continue to be an attractive one.

Both NSC and tax-saving FDs can jointly feature in the portfolios. The regular interest payout option can be chosen for tax-saving FDs to ensure that liquidity needs are met; meanwhile investments in NSC can provide for lump sum returns on maturity.

Assured Return Schemes

	PPF	NSC	Tax-saving FDs
Coupon rate (pa)	8.00%	8.00%	8.00%
Interest frequency	Compounded annually	Compounded half-yearly	Compounded quarterly
Effective rate (pa)	8.00%	8.16%	8.24%
Interest receipt	On maturity	On maturity	On maturity
Tax benefit on investment	Deduction under Section 80C	Deduction under Section 80C	Deduction under Section 80C
Tax benefit on interest earned	Exempt under Section 10	Eligible for deduction U/S 80C	Nil
Tax rates		**Post-tax returns***	
Nil	8.00%	8.16%	8.24%
10%	8.00%	7.33%	7.40%
20%	8.00%	6.50%	6.56%
30%	8.00%	5.66%	5.72%

*Education cess charged at 2.00% has been considered while computing post-tax returns.
pa: per annum

Capital Gains Bonds: Tax-savings minus gains

When investors are faced with an option to either pay tax or save tax through investments, they instinctively opt for the latter. Their rationale - why pay tax and that too when you can save tax by investing and making a return on it?

To be sure, tax-saving is just another investment activity and it demands that investors at all times have their on eye on the 'potential return' and the asset allocation. The decision whether to pay tax or invest must be made after considering these cornerstones of investing. Within tax-saving, if an avenue does not offer an adequate return and the only option staring at you is to pay tax, then financial prudence demands that you pay the tax.

If you are wondering, why we are talking of financial prudence while discussing something as basic as capital gains bonds, it's because you will need it in abundance while taking a decision on whether to invest in them or not. There are two reasons for this - first is the rather unattractive rate of interest offered on capital gains bonds. Second and more importantly, further issue of capital gains bonds in this financial year (ending March 31, 2007) can be counted out given the widely-circulated reports suggesting that the quota of capital gains bonds for this year has already been exhausted.

So if investors have already sold property before September 30, 2006, they might have no option but to pay tax on capital gains for this financial year. If you ask us, that's not bad news, because of reason one stated earlier.

This article, then, will appeal particularly to investors who haven't yet sold property, but are considering the move in time. We can recommend at least 3 options for them.

But first let's understand a few points about capital gains and how the tax liability on it is calculated. When you sell a capital asset, like house property or gold for instance, at a profit (which should be quite common if you sold property in the recent past) you make a capital gain. If this gain is made from property that was held for more than 36 months, it qualifies as long-term capital

Table 1

Cost of Purchase (Rs)	1,200,000
Sale Proceeds (Rs)	3,500,000
Date of Purchase	01-Mar-95
Date of Sale	01-Mar-06
Cost Inflation Index for the year of purchase	259
Cost Inflation Index for the year of sale	519
Sale Proceeds (Rs)	3,500,000
Less: Indexed Cost of Purchase (Rs)	2,404,633
Long-term capital gains chargeable to tax (Rs)	1,095,367
Long-term capital gains tax @ 20%	2,19,073

gain (if property is held for less than 36 months, its short-term capital gain). When you clock a capital gain, you attract a tax liability. An illustration will help you understand this better.

In our example, a property purchased for Rs 1,200,000, sold for Rs 3,500,000 will attract a capital gain of Rs 1,095,367 after adjusting for inflation. With the 20% tax rate on long-term capital gains, you have a tax liability of Rs 219,073 on your hands.

Now for the good news, the tax liability of Rs 219,073 (from our illustration) can be 'dispensed of' comfortably. Actually, you have 3 ways of doing that.

1) Invest in capital gains bonds

The easiest option of course, is to invest in capital gains bonds. These bonds (issued by REC (Rural Electrification Bond) and NHAI (National Highway Authority of India) attract tax benefits under Section 54EC. Put simply, this Section states that if the capital gains (Rs 1,095,367) are invested in stipulated bonds within 6 months of sale of asset, you are 'relieved' from paying capital gains tax.

In Table 2, we have illustrated how an investment in capital gains bond is likely to pan out. We were constrained by the lack of information on the coupon rates on capital gains bonds as they haven't been issued in quite some time. We have assumed a rate of 5.50%, which is quite realistic and in line with the rates on the last few issues.

Since you do not have to pay the tax on capital gains, the entire capital gains can be invested in the bonds. We have assumed that the investor is in the highest tax bracket, so interest earnings will be taxed at the 30% tax rate plus 2% education cess.

This option will appeal particularly to investors who do not want to pay the capital gains tax and in the process are willing to invest in a low-risk, low-yielding investment.

Table 2

Long-term capital gains (Rs)	1,095,367
Tax saved at time of investing (Rs)	219,073
Effective amount invested (Rs)	876,294
Coupon rate	5.50%
Tenure (years)	3
Maturity proceeds (Rs)	1,225,646
3 Yr CAGR returns*	11.83%

** Returns are compounded annualised and adjusted for tax benefits*

2) Pay tax and consider other avenues

If you have bought our argument that it 'pays' to give capital gains bonds a miss in favour of more lucrative avenues, then this option will appeal to you. Of course, for that you have to qualify as a risk-taking investor, because the more lucrative avenue in question is the equity-oriented fund, also known as equity-linked saving scheme (ELSS). If you have the ability to take on some degree of risk, then your capital gain proceeds (net of tax paid) are best invested in well-managed equity funds funds. In fact, you can kill two birds with one stone by investing a portion of the

money in tax-saving funds (which attract Section 80C tax benefit, but have a 3-Yr lock-in). That way you clock a return (which is linked to equity markets) and make a tax benefit on the same. However, you must note that only investments upto Rs 100,000 are eligible for tax benefits in these funds; you are free to invest further, but you will not earn tax benefits on the surplus amount.

While it's impossible to comment with accuracy on how much return stock markets (and therefore equity funds) are going to clock over the next 3 years, it is possible to make well-informed estimates. Corporate India's performance over the last few years appears relatively well-entrenched and in our view, the broad market should return 15% CAGR (compounded annual growth rate) over 3-Yr. However, investors should expect volatility on the way, because we don't believe this growth will be uneventful. hat is why, it is imperative that this path is chosen only by investors who have the stomach for above-average risk.

Table 3

Diversified Equity Funds	3-Yr*
HDFC Top 200	48.71%
Franklin India Bluechip	45.77%
Sundaram Growth	43.93%
Balanced Funds	**3-Yr***
HDFC Prudence	38.79%
DSP ML Balanced	34.19%
FT India Balanced	32.32%

Source: Credence Analytics. NAV data as on November 21, 2006. Growth figures are compounded annualised.

Table 4

Long-term capital gains (Rs)	1,095,367
Less: Long-term capital gains tax paid (Rs)	219,073
Net amount invested (Rs)	876,294
3-Yr returns*	15.00%
Tenure (years)	3
Maturity proceeds (Rs)	1,332,733

** Returns are compounded annualised*

3) Buy another property

Another option available to the investor (under Sections 54 and 54F), although suited mainly for investors in real estate, is to invest the capital gains in another residential property. It does not matter whether the property is acquired or constructed so long as the transaction adheres to taxation laws. This property must then be retained for a minimum 3 year period to preserve the capital gains; should you sell the property before that, you will have to pay the capital gains on the earlier property, (in addition to the second one, if you have made a capital gain).

Whether investors opt for the capital gains bond route or choose to pay the tax and select the riskier mutual fund route, should depend on their risk profile. If low risk avenues that assure a return, even if unattractive, is what suits you then you don't need to look beyond capital gains bonds. However, if you are the kind of investor who does not like to compromise on the return and can take on risk for the same, then the mutual fund route is right up your alley.

Infrastructure Bonds: Not good enough!

Over the last 12 months, there has been little development in the lot of the risk-averse investor looking for tax-saving options. Tax-saving fixed deposits have now been added to the gamut of assured return tax-saving instruments. However, on the returns front, unfortunately, it is only a case of investor expectations catching up with the harsh realities of 'realistic' interest rates.

Small saving schemes like the NSC (National Savings Certificate) and PPF (Public Provident Fund) may have escaped this reality, but that is because rates are government-controlled. However, infrastructure bonds (since they are usually backed by private issuers) are not linked to the government and therefore have more realistic interest rates. So the proverbial 'free lunch' is indeed missing.

Infrastructure Bonds

Tax rates	Returns	Post-tax returns
Nil	5.50%	5.50%
10%	5.50%	4.94%
20%	5.50%	4.38%
30%	5.50%	3.82%

This was the interest rate on the infrastructure bond issued last year and must be treated as indicative

Why are we so negative on infrastructure bonds? The reasons are not difficult to fathom. To begin with, the return (since that accounts for maximum investor interest) is far from flattering and even more dismal are the post-tax returns. As a matter of fact, for investors in the higher tax groups, infrastructure bonds are just not good enough.

Notice, how the post-tax return dips progressively for investors in higher tax brackets. It's bad enough for the investor in the lowest tax bracket at 4.94%. It gets even more dismal for investors in the 20% tax bracket (4.38%). In the highest tax bracket, they are ridiculously low at 3.82%! It is apparent why we don't have a very positive view on infrastructure bonds. At the returns on offer, they don't even provide for inflation (assumed at 6% going forward). The more informed investors will have realised that the 'real return' (this equals post-tax return net of inflation) on an infrastructure bond at current rates is actually negative!

All is not lost for the risk-taking investors, though. Investors who are willing to take risk can expect commensurate rewards over a similar lock-in period. This is possible through investments in tax-saving mutual funds, which like infrastructure bonds also have a 3-Yr lock-in. Of course, the similarity ends with the lock-in; in terms of returns, there is no guarantee as performance of a tax-saving fund is at the mercy of stock markets which can be quite volatile over the short-term. However, over a 3-5 year time frame, based on the performance of Indian companies, we expect the broader market to give a return of 15% CAGR

(compounded annual growth rate). Well-managed tax-saving funds are likely to perform on similar lines, if not better. In terms of tax benefits, the capital appreciation on tax-saving funds are tax-free (you only pay 0.125% Securities Transaction Tax) and dividends on tax-saving funds are also not taxable.

However, risk-averse investors who are looking for a shorter lock-in period and are willing to compromise on returns in the process, can consider investing in infrastructure bonds. For the rest however, it's best to look for alternative options and in the absence of any, pay the income tax!

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