INSURANCE

Highest NAV guarantee plans come with a charge that lowers net returns

Your queries
Suresh Agarwal

I have a pure term policy, Amulya Jeevan, from LIC for ₹50 lakh. Now, I want to take a similar policy for my wife, who is 34 years old, and daughter who is four. Should I take the same policy for both of them?

—Biswaroop Sen

Yes, it is always advisable to go for the term plans first with appropriate covers. Several insurance companies now offer term plans online, which tend to be cheaper by about 10-15% than the conventional term plans sold offline. Compare offerings from different insurers for the gender, age, cover amount and policy term as per your specifications and buy the plan that suits you the most.

I have a mediclaim policy from New India Assurance for ₹3 lakh each in a four-member family. What are critical illness and personal accident riders and how can I get both of them added to my policy?

—Sumant Kumar

Riders are add-on covers that can be taken over and above the base plan to extend your risk cover at a nominal charge. For example, a critical illness rider offers cover against pre-specified critical illnesses. If the life assured suffers from any of the pre-specified illnesses, the benefit payout is made. Generally, critical illness and personal accident riders are available with life insurance plans and you can approach the insurer for this inclusion.

I have come across many products with the highest NAV guarantee. How does the guarantee work and for how long do I need to invest in these products?

—Anuja Sinha

Highest NAV guarantee plans pay the highest NAV achieved by fund units over a specified period of time. These plans come generally for policy terms ranging between seven and 10 years. They work on the constant proportion portfolio insurance (CPPI) model, which, while limiting downside in the event of falling stock markets, also tend to constrict gain and leverage that could be achieved through participation in rising markets. In such plans, given the guarantee, over the policy term, a significant portion of the fund stays invested in debt market instruments. Depending on the percentage of guarantee offered, there is also usually a separate guarantee charge, which lowers the investment component. Such plans will appeal to investors with lower risk appetite who do not mind foregoing higher equity returns and paying extra charges for the sake of guarantee.

After retirement, I have accumulated a corpus of ₹20 lakh, out of which I want to invest ₹15 lakh in an annuity scheme to get regular pension. How much monthly pension can I expect, what will the interest rate be and will the payout be same throughout my life?

—Sooman Prabhu

Annuity rates vary from company to company. You have to check with the insurance companies regarding their rates and the monthly payout they can provide for life.

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■ *Send your queries at fepersonalfinance@expressindia.com*

SINGLE PREMIUM ULIPS

Not everyone's cuppa

These life insurance products suit those who have a lump sum to invest or have irregular income, but they can prove disadvantageous from tax point of view

Saikat Neogi

AS the tax-planning season draws near, insurance companies are planning to launch a series of single-premium unit-linked insurance plans (Ulips) and are aggressively selling their existing ones too. These are products where the policyholder pays the premium just once during the policy term and he or she gets the cover throughout its tenure.

In fact, after the segment regulator, Insurance Regulatory and Development Authority (Irda), introduced new guidelines on Ulips last year, sales of single-premium products—both at the individual and the group platform—have grown vis-a-vis non-single premium products.

Data for first-year premium of life insurance companies for the period ended September 2011 show that 22 private sector life insurers mopped up ₹2,102.47 crore in the period against ₹1,921.97 crore during the same period in 2010 in the individual category.

In the group category, the growth of single premium was almost 40% during the same period. In contrast, the mop-up in the individual non-single premium category dropped 44% in the same period. Life Insurance Corporation, the market leader in single-premium products, increased its single-premium market share in the group category.

For insurance companies, selling single-premium products reduces their cost as they do not have to pursue the renewal every year and there is no chance of the policy getting lapsed. Single-premium products suit those with irregular income or who have a lump sum available to invest. The new Irda guidelines have made it clear that single-premium policy cover will now be based on the age of the policyholder rather than the policy's tenure. Though the insurance regulator has fixed 2% commission payable to agents for selling single-premium policies, the products come with higher premium compared with regular premium policies and the entire sum is to be invested at one go, making it lucrative to sell them.

Group segment includes gratuity, superannuation, leave encashment and other retirement savings solutions of companies. The premiums paid by the corporates are tax-deductible expenses and the benefits received by the employees are also tax-exempt, subject to I-T rules. Prakash Praharaj, chief financial planner, Max Secure Financial Planners, says with the rising interest rate scenario and, especially, when the 10-year G Sec yield is around 9%, manufacturers are able to offer higher rates on these products. "The corporates, in turn, are benefiting by negotiating with various manufacturers for a better rate. But the manufacturers will face challenges in future to maintain the rates when the interest rate declines," he says.

At the individual level, the growth of single-premium products is also driven by the growth in home loan as banks are insisting on insurance cover for the loan. Moreover, banks offer loan on the premium, which does not involve immediate cash outgo by the borrower. Though most of those who sell single-premium Ulips will say that the policy will give tax benefits under Section 80 C of the Income Tax Act, 1961, one must also read the sub section 3 of the 80C, which says that a deduction is available only up to 20% of the sum assured on the policy. This sub-clause clearly means that the entire premium invested in a single-premium policy cannot be claimed as a deduction.

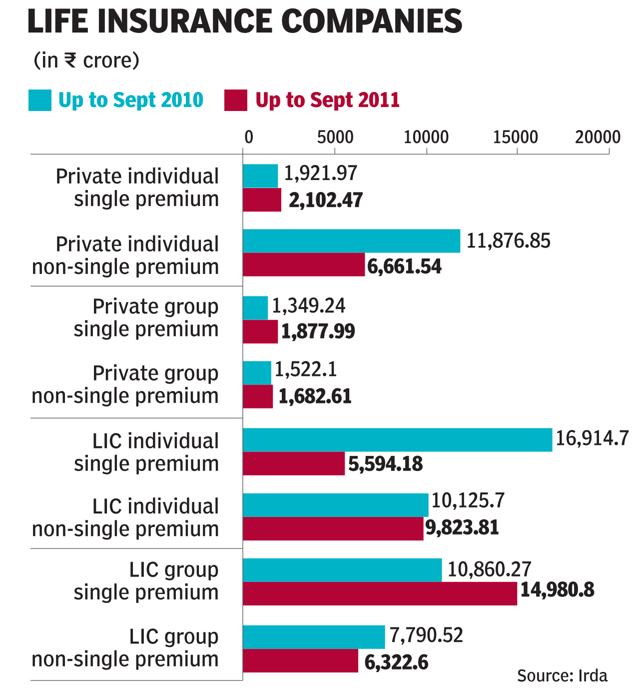
As per Irda norms, the minimum sum assured for a single-premium product has to be five times the premium paid. The sum assured cannot be reduced, except in the last two years of the policy. Even at maturity, as per Section 10 (10) D, the premium should not exceed 20% of the cover in any year of the policy's tenure so as to make the amount tax-free at maturity. Otherwise, the maturity amount is added to the total income of the person for that particular year. So, single-premium policies are disadvantageous from the tax point of view. For investors in the 20-30% tax bracket, the tax payable will be higher than lower tax bracket.

Analysts also say that after the series of policy rate hikes by RBI, it is now anticipated that the interest rate has reached the peak and may not increase further. Once inflation stabilises, the rates will start declining and debt funds will generate good returns.

Some insurers have made the most of this signal by selling single-premium products to prospective buyers; some have even convinced investors that it is the right time to enter the equity market. Vikas Kumar Mahajan, a certified financial planner, says it is important for an investor to time the market when investing in single-premium products.

"One should invest in debt fund when the market is at its peak and switch to equity when it has bottomed out," he says. Look at products where one can switch funds without any charges and use the option at regular intervals to balance the asset allocation.

FIRST YEAR PREMIUM OF LIFE INSURANCE COMPANIES



Tax talk
Shankar P B

Esops better than stock purchase plans

Companies often reward their employees with their stock, either in the form of employee stock option plans (Esops) or employee stock purchase plans (ESPPs). Esops are stock options granted to employees over a vesting period, where the employee is given the right to purchase the company's shares at a predetermined price or the exercise price. If the employee does not exercise the option within a time prescribed by the company, the option automatically expires.

ESPPs allow employees to use their salary to purchase the stock of the company, usually at a discounted price. Unlike Esops, ESPP holders do not have any option, but are mandated to pay the exercise price usually by way of monthly deductions from their salary.

Employees can realise the benefit by selling the shares in the market, subject to a lock-in period, which starts from the date of the grant for Esops and, for ESPPs, from the date of allotment of shares. While the minimum lock-in period for listed shares is one year, a company may choose to extend it.

Both schemes have the following tax implications for an employee:

At the time of receiving the shares. The value of the shares after deducting the price paid by the employees is taxed as salary income at normal tax rates. In case of Indian listed shares, the value for tax purposes is based on the traded price in the stock market (on exercise), and, in other cases, it is left to the discretion of the prescribed valuer.

On holding the shares. Dividends received for shares of the Indian companies are exempt from tax in the hands of the employees/shareholder.

At the time of sale. Any gain beyond tax value of the shares may be subject to capital gains tax, depending on whether the shares are listed in India and the period of share holding. For listed shares where the securities transaction tax is paid, there would be no tax if shares are held for more than one year, but taxed at 15.45% if held for less than one year. In case of unlisted shares, the tax rate is 20.3%, if held for more than one year; if held for less than a year, it is taxable at normal rates of taxes (based on the income slab).

While ESPP holders have the facility to mobilise savings on a periodic basis and enjoy the shareholder benefits before Esop holders, Esops generally score better, more so in case of increase in share prices, as Esop holders' cost would be pre-fixed at the time of grant (where the prices are lower). For ESPP holders, on the other hand, the average price would increase with each subsequent allotment. Esop holders are also protected from the downside by providing them the option of opting out when the expected market price is less than the exercise price.

■ *The writer is senior tax professional, Ernst & Young*

MFs with low portfolio turnover ratio yield higher returns

Your money
Fatima Sayed

Next time, when you invest in mutual funds, do make sure that you understand the company's portfolio turnover ratios (PTRs) as higher the ratio, the lower will be the returns from the portfolio. In MFs, equity funds diversify their holdings to mitigate risk. Each fund invests in more than 20 stocks to reduce the risk and benefit from performance across segments.

But like any investor, even MFs churn their portfolio to weed out bad stocks from their portfolio or exit from the fund, which has reached its target. An investor must check which asset management companies' an MF is investing in. He should also see how old the fund has performed, its expense ratio and who manages the funds. And, one also needs to keep an eye on the PTR.

PTR numerically measures the trading activity in a fund's portfolio. The PTR is a percentage of the portfolio that is bought and sold in exchange for other stocks. The portfolio turnover is calculated by looking at the amount of new securities purchased and the amount of securities sold over a particular period. Whichever amount is less gets divided by the average net assets of the fund, giving the PTR. If the portfolio is churned many times during a year, the fund will incur higher transaction costs. If the fund manager has chosen superior stocks that gives alpha returns after considering all the transaction costs, it's fine. However, if the fund is churning less and generating similar or higher returns, the former would seem unattractive.

Larger PTR will increase the expenses while churning. When the fund's expenses increase, it, in turn, reduces the returns or yields of the fund. It might seem fine compared with equity funds where you will earn around 15% if you are investing for a long period and pay around 1.5-2% on expense ratio.

But this is not viable in case of debt funds. The PTR and expense ratio are very critical parameters while selecting a debt fund. In debt funds, if you have a high turnover and corresponding high expenses, your yields would be depreciated by a huge margin over the long term because, here, the yields are in the range of 5-9% on an average and, thus, even a 0.5% higher/lower expense ratio matters.

An excellent case of how PTR can help in investing would be that of mid- or small-cap fund as they are relatively under-researched stocks. Therefore, it's possible that the fund has a high turnover. The accompanying graphic will give you an idea of what high portfolio turnover can mean. The funds in the table are of the same category, but with varying expenses and PTR. It's seen that funds with low PTR and expenses, yield higher returns. Thus, as a thumb rule, all other features and comparable returns being the same, choose the one with a low PTR.

■ *The writer is mutual fund analyst at Bonanza Portfolio*

HOW THEY STACK UP

Scheme	Expense ratio (%)	1 year P2P returns (%)	PTR (%) Aug 11
HDFC Midcap Opportunities Fund	2.01	2.05	24.23
UTI Midcap Fund	2.21	-9.46	59.38
Kotak Midcap Fund	2.34	-10.61	277.68

INTERVIEW: HILDY RICHELSON

PRESIDENT, SACRSDALE INVESTMENT GROUP

Bonds better investments than stocks in the long term

For Indian investors, an all-bond portfolio is an essential ingredient in the development of a plan for financial independence. **Hildy Richelson,** *a bond expert and President of US-based Scarsdale Investment Group in an email interview to* FE's **Saikat Neogi** *says, for a buy-and-hold type of investor, investing in bonds is about creating a cash flow for income and the reinvestment of principal.*

Conventional wisdom says investors need to strike a comfortable balance between risk tolerance and return expectations. Do you think, in the wake of the 2008 financial crises, that conventional wisdom is changing?

We do not believe in diversifying assets to anything riskier than high-quality bonds. Historically, investors seem to have a great tolerance for risk until they lose money. Stock investments, for example, are promoted with the idea that, in the long run, investors will have returns that exceed the return on bonds. When markets are very volatile, the belief that if you stay invested, your retirement will be secure appears unrealistic. How does a person know that when he is ready to retire, the stock market will consistently reward him with rising prices? Fixed-income investments are more predictable. If an investor purchases high-quality individual bonds, then he will have a cash flow from the bonds as well as a return of their principal at a specific time.

For a risk-averse investor, will an all-bond portfolio be a surefooted strategy to ensure results? How do you see that in the Indian context?

For a resident of India, the all-bond portfolio is an essential ingredient in the development of a plan for financial independence, which we define as more income coming in than going out. It is important to emphasise that high-quality individual bonds can enable anyone with a mindset to achieve financial independence to do so. In fact, in our book *Bonds: The Unbeaten Path to Secure Investment Growth,* we explain why we prefer individual bonds to bond funds, which we consider to be quasi-stock investments.

Since credit default swaps (CDS) have recently been introduced by the RBI, bond buyers should consider how they might affect the repayment of their bonds. Though CDS are supposed to help issuers manage their debt, it seems that there are often unfortunate results. In the US, it is not unusual that small and large issuers are frequently misled by the investment banks about the value of derivatives. The issuers then find themselves owing large amounts to the bank, rather than saving millions of dollars.

Various studies show that equities give better returns in the long run. Given the increasing volatility in equities, do you think that will become a myth in the years to come?

In the US, over the last 10, 20, 30 and 40 years, bonds (as represented by US treasury bonds) have outperformed stocks (as represented by the S&P 500 Index). The two crashes in 2000 and 2008 have changed the stock versus bond comparisons. For an individual buy-and-hold investor, investing in bonds is about creating a cash flow for income and the reinvestment of principal. It is not about trading. When we think about selling, we ask ourselves: What else might I do with the cash? If you have a mortgage to pay off, or you have a business that needs capital, then it might make sense to sell your appreciated bonds. If you are not living on the income from your bonds, then you have cash flow that you can reinvest at higher rates in the event of inflation, in effect income-averaging to better returns. The question is not: Which horse do you want to ride, stocks or bonds? The question is: Do I want to speculate and gamble, or do I want to create a cash flow that might lead to financial independence?

"For a buy-and-hold investor, investing in bonds is about creating a cash flow for income and the reinvestment of principal. It is not about trading...If you are not living on the income from bonds, then you have cash flow that you can reinvest at higher rates in the event of inflation"

Apart from structured products, what are the important factors that an investor should look at before investing in bonds?

Most importantly, an investor should consider the issuer's ability and willingness to repay its debt. In this regard, larger issuers that draw resources from many sources are usually a better bet than a small issuer that has limited resources. If bonds are callable, then the investor needs to consider if the yield-to-call is acceptable first before considering yield-to-maturity. If the coupon is low compared to newer issued bonds, then the consideration is reversed: yield-to-maturity then becomes more important. Also, the investor should consider if he can hold the bonds until they mature so he does not have to sell, incur additional transaction costs, and possible losses.

How can investors maximise their returns on bonds in the long term?

Investors can maximise their returns on bonds by buying only high-quality bonds, minimising their transaction costs and not losing any money. They should target the maturity dates of the bonds to times when they want the principal returned to them. They should reinvest the interest at the most attractive rates, keeping in mind that their principal needs to be protected.

How do you think the power of compounding works best in bonds?

The power of compounding works best when an investor doesn't try to time the markets. After the stock market fallout in 2008 and 2009, the financial advisors in the US knew that we would have a massive inflation.

They invested client funds in bonds maturing in less than five years. However, instead of inflation, we have had declining interest rates. We look at inflation as the upside case because you are able to reinvest the interest and principal payments at higher rates. Too much inflation, of course, is not good because it erodes the value of everything.