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EXPERTSPEAK

How to choose among savings accounts, FDs and liquid funds

State Bank of India, the country's largest lender, recently announced that its savings account deposits above ₹1 lakh will earn an interest rate that is linked to the repo rate, an external benchmark, from May 2019. SBI's move is being seen as a nudge to customers to move their surplus money from their savings bank accounts to fixed deposits that give higher yields. More banks are expected to follow in SBI's footsteps. Shaikh Zoaib Saleem asks experts if, in such a situation, it makes sense to stick to bank savings accounts to park one's surplus money, or to move to fixed deposits or liquid mutual funds

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Returns will improve if surplus money is moved to FDs

The recent move by the State Bank of India (SBI) to link its savings bank deposit rates to the repo rate makes the determination of interest rate transparent. This will have a bearing only on individuals with deposits above ₹1 lakh.

For such savings accounts, SBI will give a rate of 3.5%, which is 2.75% below the repo rate (the rate is 3.5% for other SBI savings accounts too). This is a negative real returns on a net of tax basis. Investors typically use savings account to park their surplus and exigency funds. With rates expected to head lower, returns could be improved by allocating the portion needed for an exigency into fixed deposits (FDs). Some FDs provide immediate liquidity, like a savings account, even on non-working days.

The balance exigency funds can move to liquid schemes of mutual funds as they provide better post-tax returns. Investors looking to further optimise returns by about 1% and with a short-term outlook can look at investing in ultra short-term funds as they provide superior risk-adjusted returns.

Keep one-third of contingency fund in savings bank account

From a financial planning perspective, all your investments should be goal-driven. Even maintaining money in a savings account should be linked to a specific goal.

If someone is in a stable job, a three-month contingency fund is advisable. This is other than the family's regular expenses. For instance, if someone has a monthly expense of ₹50,000, including loan repayment EMIs, the person should have a contingency fund of ₹1.5 lakh. Of this, keep just ₹50,000, that is one third of your contingency fund, in a savings account and the balance in a liquid fund. The reason for this distribution is that you should be able to withdraw the first ₹50,000 immediately if required. For the rest, you can choose liquid funds that offer liquidation at the earliest.

Money in excess of this should be deployed based on your financial goals and the investments and instruments need to be decided accordingly. It is important to have a financial plan in place. The asset categories and allocation will vary from person to person.

Liquid funds score over bank accounts in terms of returns

The linking of savings bank deposits with an external benchmark makes the investment case for liquid funds stronger. Given the nature of liquid funds, their track record and incremental returns, investing in them will be superior compared to investing in savings bank accounts.

For medium-term investments, there is more comfort among investors with FDs. Mutual funds are far from giving that kind of comfort, but we are making progress. People invest in FDs for two-three years and above, while liquid funds are for cash surplus that is waiting to be deployed. But for short-term deposits of three to six months, liquid funds are superior in terms of returns and liquidity.

For investments of one to two years, you are better off investing in listed corporate bonds because here long-term capital gains are applicable after 12 months. But if the investment period is above three years, then fixed maturity plans or FMPs are much better compared to FDs due to diversification, indexation benefit and lower costs.

With interest rates likely to go down, FDs are a viable option

Every individual is comfortable with different levels of savings account balance. The choice for deployment of excess money depends on what asset class you are comfortable with and how much risk you are ready to take, and the period of investment.

If someone has a surplus for the short term, they would think of choosing between a liquid fund and an FD. When deciding between the two, you have to consider the fact that a liquid fund is market-linked and, hence, returns are not guaranteed. Depending on tenure, you also have to keep tax calculations in mind. On the other hand, FDs have a fixed return but also have a TDS (tax deducted at source).

Another important factor will be interest rates in the near future. If rates are expected to go higher, then I would do a short-term investment now and go for an FD when the rates go up. At present, we know that the rates are going down. In the current situation, I would go with the security of an FD for a longer term rather than liquid funds that have market volatility.