Fds vs. debt funds: What's the right choice for your investment portfolio?

Introduction

You may have read several books or seen movies where a character has to choose between different paths and live by the consequences each course brings along. Selecting the right financial product can also make a huge difference in your life. Whether opening a Fixed Deposit (FD) or investing in debt mutual funds, each financial product has its unique benefits and drawbacks. In this article, we can help you navigate the world of financial products, so you can make an informed decision between FD vs debt funds and pick the one that suits your needs.

Things to check when choosing between debt mutual funds and FDs

1. **Risk**

FDs are more or less considered to be risk-free, which is why they are popular among most investors. However, they do contain some risks. The bank may default in extreme situations. And even though the principal and interest are guaranteed up to Rs 5 lakh, amounts higher than this will be subjected to risk. Additionally, FDs are prone to inflation risk as they may deliver returns lower than the inflation rate.

Debt mutual funds are also considered low-risk investments, similar to FDs. However, they, too, may pose some risks, such as interest rate risks and credit risks. When interest rates increase, the value of fixed-rate investments falls, and vice versa. This results in fluctuations in a debt mutual fund's Net Asset Value (NAV) and may affect returns. Likewise, debt funds also carry credit risk as you are primarily lending money here, and the borrower may not return the money. However, various credit rating agencies rate bonds.

This can help you pick safer investment options.

Note: It is important to keep in mind that all investments contain some amount of risk.

2. **Returns**

In the case of FDs, you get guaranteed returns at a pre-decided rate as per your tenure. In the case of debt mutual funds, the returns you get depend on the type of fund you choose. Since debt funds do not have a fixed return rate, they have the potential to deliver higher returns than FDs.

3. Liquidity

Debt mutual funds are generally considered to be more liquid than FDs. Open-ended debt funds can be bought and sold anytime, allowing you to access your funds quickly. In contrast, FDs have a fixed tenure and you may have to pay penalties for early withdrawals, subject to the bank's rules.

4. Taxation

FDs and debt mutual funds are taxed differently in India. The interest earned from an FD is added to your income and taxed as per the applicable income tax rate. On the other hand, gains from debt mutual funds are taxed as short-term capital gains if held for less than three years and long-term capital gains if held for more than three years. Short-term capital gains are added to your income and taxed at the applicable income tax rate. Long-term capital gains are taxed at a rate of 20%, along with the indexation benefit. The indexation benefit adjusts your gains with respect to inflation, so you pay less tax.

5. Transparency

Debt mutual funds are highly transparent and provide regular updates on their NAV and holdings. You can track the performance of your investment and see where the money is being invested. Mutual fund houses are also required to disclose information such as their investment objective, risk profile, and past performance with investors. FDs may not provide as much transparency. You typically do not have access to information about how the bank is using your money.

Debt mutual funds vs fixed deposits

Points of difference	Fixed Deposits	Debt mutual funds
Risk	Low	Low to moderate
Returns	Fixed	Market-linked
Liquidity	Low	High
Transparency	Low	High
Types	There are several types of FDs, such as cumulative, non-cumulative, standard, tax-saving, senior-citizen, flexi, Non-Resident Indian (NRI), and corporate FDs.	There are 16 types of debt funds as per the categorisation of the Association of Mutual Funds in India (AMFI). Debt funds can also be classified as active debt funds and passive debt funds based on their management style. Interestingly, passive debt funds such as passive liquid funds, passive gilt funds and target maturity funds are gaining traction these days.

Conclusion

FDs may be suitable if you are looking for low risk and fixed returns. On the other hand, debt funds can be ideal if you are looking for market-linked returns and are ready to assume relatively more risk for the same.