Target Maturity Funds vs Traditional Investment - Which is Better?

Risk is one of the first things you may consider when selecting an investment. If you like to stick to the low-risk segment, you may consider options like debt mutual funds, fixed deposits (FDs), etc. Target maturity funds are among the newest debt funds on the block. They are slowly climbing to the top of the preference ladder as far as debt mutual funds are concerned. So, can they tower over traditional investment options like fixed deposits (FDs), too? Keep reading to find out the winner in the tussle of target maturity fund vs traditional investment options like FDs.

Understanding target maturity funds

Target maturity funds are open-ended debt mutual funds that have a fixed maturity date. These passive funds invest in State Development Loans (SDLs), Government Securities (G-Secs), and PSU bonds. They mimic the composition of the underlying index they follow, for example, the Nifty PSU bond.

Since target maturity funds invest in bonds, you get to earn regular interest. This is paid to you along with the principal at the time of maturity. Moreover, the interest earned is reinvested in the fund to earn more through the power of compounding.

Target maturity funds may be ideal for you if you have a medium to long investment horizon. However, it may be advised to stick to the maturity of the fund to yield a stable return.

Decoding traditional investments like FDs

For decades, FDs have been the go-to option for risk-averse investors because they offer guaranteed returns. As the name suggests, an FD is an investment with a fixed maturity period ranging from a week to 20 years. It offers a fixed interest rate that varies across banks. Usually, the interest rate is higher for senior citizens.

Now that the basics are clear let's move to some other differences.

Comparison: target maturity fund vs traditional investment

Points of difference	Target Maturity Fund	Fixed Deposit
Offered by	Asset management companies	Banks and Non-Banking Financial Companies (NBFCs)
Liquidity	They are opened-ended and can therefore be redeemed anytime	They have a lock-in period, and partial withdrawals may incur penalties.
Tax benefits	Gains on funds held for less than three years are added to your annual taxable income and taxed accordingly. Gains on funds held for more than three years are taxed at 20% after indexation benefits. This means the amount is adjusted for inflation and then taxed.	The interest amount is added to your taxable income for the year and taxed accordingly. However, five-year fixed deposits offer tax benefits of up to Rs 1.5 lakh per annum under Section 80C oft fthe Income Tax Act, 1961.

Short-term gains on target maturity funds are taxed just like FD returns. However, in the case of long-term gains, target maturity funds may be more tax-efficient if you fall under tax brackets higher than 20%. Let's understand how.

Say, you invested Rs 1 lakh in an FD and Rs 1 lakh in a target maturity fund in FY 2016-17 for 3 years. And let's assume that you fall under the highest tax slab of 30%.

Column	Particulars	Fixed Deposit	Target Maturity Fund
A	Investment amount (2016-2017)	Rs 50,000	Rs 50,000
B	Assumed rate of return	6%	6%
C	Investment tenure	3 years	3 years
D	Indexation benefits	Not available	Available
E	Maturity value (2019-2020)	Rs 59,551	59,551
F	Indexed cost of investment#	Not applicable	Rs 54,735#
G	Taxable amount	Rs 9551 (E-A)	Rs 4816 (E-F)
H	Applicable tax	Rs 2865+Rs 115 = Rs 2980 (G X 30% tax = 2865) (2865 X 4% cess = 115)	Rs 963+Rs 39 = Rs 1002 (G X 20% tax = 963) (963 X 4% cess = 39)
I	Post-tax investment value	Rs 56,571 (E-H)	Rs 58,549 (E-H)

#Note:

You can get the Cost Inflation Index (CII) for every year from the official website of Income Tax of India. Additionally, you can adjust your investment for inflation using the following formula:

Indexed cost of investment = Investment amount X CII for redemption year/CII for investment year

The CII for 2016-17 is 264 and for 2019-2020 is 289. Therefore, the indexed cost of investment = 50,000 X 289/264 = 54,735.

Clearly, target maturity funds can be more tax-efficient in certain cases. Let's look at some of their other benefits.

The advantages of target maturity funds

o Low risk: Target maturity funds offer better immunity against interest rate risk as they hold their bonds until maturity. Moreover, since they are primarily invested in government securities, the default and credit risk are lower compared to other debt funds.

o High liquidity: Target maturity funds are open-ended funds and, therefore, highly liquid. Although they are often compared to fixed maturity plans due to their fixed holding period, they are more akin to liquid funds in terms of quick redemption options.

Conclusion

Target maturity funds can be an excellent addition to your debt portfolio if you have a fixed goal in sight and can stick to the maturity date. However, if tax savings is also your goal, then you can opt for five-year FDs. No matter what you choose, thoroughly research and pick the most suitable product for your needs.