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On Your Marks

Don't put off your tax planning. Get into an Equity Linked Saving Scheme now and you won't have cause to regret it come next March.

By Mahesh Nayak

On February 28, 2005, finance Minister P. Chidambaram, while announcing his Budget for the year 2005-06 removed a ceiling of Rs 10,000 on investments in equity linked savings schemes (ELSS) that would be allowed as part of the Rs 1,00,000 that individuals could invest in tax-saving instruments (the ceiling was part of Section 88 of the it Act that was scrapped and replaced with Section 80C).

That meant they could invest the entire Rs 1,00,000 if they so desired in ELSS. The scrapping of Section 88 also meant individuals with a gross annual income higher than Rs 5,00,000 were now eligible for similar benefits. Ravikant Koshy, a Mumbai-based investor (his name has been changed on request), is one of several thousands that have used this change to advantage. He upped his investments in ELSS to Rs 30,000 and saw that grow to around Rs 55,000 (which shouldn't surprise anyone; in 12 months ending March 31, 2006 ELSS returned an average of 87 per cent).

The assets under management (AUM) of ELSS have surged by 330 per cent in the same period, to Rs 7,155 crore from Rs 1,663 crore. And their contribution to the total assets managed by mutual funds has increased from 1 per cent to 3 per cent.

Better Than The Rest

Investors will discover that ELSS enjoy several advantages over other tax-saving instruments. Apart from claiming deductions under Section 80C for up to Rs 1,00,000, the lock-in period for such schemes is the shortest when compared to other tax-saving instruments such as investments in public provident fund (PPF), RBI bonds, and National Savings Certificates (NSC). Long-term capital gains on investments in equity funds and the dividend received on these is also tax free, as against interest from RBI bonds (8 per cent) and NSC that are taxable. Then, there is also the small thing about the earning potential of ELSS, much higher than those of other tax-saving instruments (see ELSS Vs

Other Tax-saving Instruments).

These, though, do not make ELSS the ideal tax-saving option for everyone. "It completely depends on the risk-profile of an individual," says Sandeep Shanbag, a Mumbai-based investment advisor. "You cannot ask a 55-year-old man to invest his complete savings in non-assured returns schemes such as ELSS." However, most investors do seem to have realised the merits of opting for an equity-linked tax-saving instrument. "People have understood that to beat inflation and get consistent returns over the long term, equity has to be part of their portfolio," explains Hemant Rustagi of Wiseinvest Advisors, who sees a shift towards ELSS.

Understanding Risk

The quantum of an individual's investment in tax-saving instruments is a function of his or her appetite for risk. While past returns from such schemes may encourage investors to put their little (or sizeable) all into them, that wouldn't be the prudent thing to do. High returns equal high risks. The ideal way to enter ELSS (as indeed, any other mutual fund scheme) is through a systematic investment plan (SIP). This does away with the need to time the market. Better still, it reduces the strain on finances at the end of the financial year when most investors move into tax-planning mode.

There are no fixed prescriptions as to how much of an individual's portfolio should be made up of ELSS (in investing, there is no one-size-fits-all rule), but there are some rules of thumb. An individual's investment in equity should be 100 minus his age (thus, for a 30 year old, it should be 70 per cent of his investible surplus). The proportion of this dedicated to ELSS will be a function of the individual's age, risk-profile and financial commitments. For instance, an individual who has just started earning and has no financial commitments can invest 100 per cent of his investible surplus in ELSS. This won't just save tax but help him or her build a good portfolio. The mandatory three-year lock-in period serves as a boon, helping the money grow (although if the individual wants a regular income, he or she can opt for the dividend option). Generally, however, most investment advisors are of the opinion that ELSS are among the better ways for an individual to invest in equities.

SIP, Don't Gulp

With systematic investment plans in ELSS, the lock-in period starts on the day the first investment is made. For instance, in 2005-06, if an investor had started investing in an equity linked savings scheme from April 2005 by way of sip, his investment of Rs 1,00,000 over the year (at Rs 8,334 a month) would have grown to around Rs 1,81,000 (assuming an average return of 87 per cent). If he had, however, made the Rs 1,00,000 lakh investment in March 2006, it would have grown by a mere 5.22 per cent to Rs 1,05,220, and the lock-in period would have started only in March 2006. For the record, if the investment had been made in April 2005, it would have grown to Rs 1,87,000, but the investor would have carried enormous risk.

Investors opting for ELSS would do well to remember that the instrument shares the characteristics of equity. "It is only over the long term that equity has the potential to outperform other comparable assets," says Rustagi. There is another benefit: with investors not being able to redeem their units for three years, fund managers have the luxury of plotting a medium-term strategy. And if investors believe that this luxury can be misused by fund managers, the very fact that outflows are a continuous process in open-ended ELSS should prevent fund managers from opting for illiquid stocks.

If all this isn't enough, look to fund houses that offer ELSS clubbed with insurance cover. Kotak Mutual Fund and Reliance AMC do, for instance, and a three-in-one benefit is not something to be scoffed at.