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SUNDARAM MUTUAL

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customerservices@sundarammutual.com
www.sundarammutual.com
(NRI): nriservices@sundarammutual.com

Contact Number: (India) 1800-103-7237
(NRI) +91-44-40831500
SMS: SFUND to 56767

Mutual funds enjoy tax advantage over most other asset types when you make capital gains. Capital gains made in equity funds, held for less than 12 months, are taxed 15.45% (including 3% education cess); if funds are held for more than 12 months, then the profits are tax free. Capital gains made in non-equity funds, if held for less than 36 months, are taxed at the income tax rate of the investor; if funds are held more than 36 months, then capital gains are taxed at 20.6% (including cess) after indexation. Most mutual fund taxation related blogs that I have come across, focus on capital gains taxation, but when you invest in market linked products like mutual funds, there are chances that you can make a loss as well. In this blog post, we will discuss tax treatment of capital losses.

What is Capital Gain or Loss?

You make a capital gain or loss only when you sell; if your fund has appreciated or depreciated in value, but you are still holding it, there is no capital gain or loss. You make a capital gain in a mutual fund scheme if the NAV of the scheme at the time of selling is more than the NAV of the scheme at the time of purchasing; you make a capital loss, if the NAV of the scheme at the time of selling is less then NAV of the scheme at the time of purchasing. Readers should note that, dividends paid by a scheme are not considered in capital gains or losses calculations for income tax purposes (there is a caveat, however, which we will discuss late).

Setting off

The most important tax implication of a capital loss in a mutual fund scheme is that, it can be set off against capital gains, depending on the nature of the loss. Let us understand this with the help of an example. Let us assume that, you have bought two mutual fund schemes in the same financial year. Before the end of the financial year, you sold both the schemes. In one scheme you made a profit of Rs 50,000 and in another scheme you made a loss of Rs 10,000. In the scheme where you made a profit of Rs 50,000 you have to pay short term capital gains at the rate of 15.45%. Your capital gains tax obligation is, therefore Rs 7,725.

What about the scheme were you made a loss? Obviously there is no tax, but under Income Tax Act, you can set off the loss against the gain. You can show both the capital gain and loss in the Income from Other Source in your ITR and net off the loss from the profit. Therefore, your net short term capital gain will be Rs 40,000 (Rs 50,000 – Rs 10,000) and your tax obligation will be Rs 6,180 only. By setting off losses against gains, you are reducing your tax obligation. Readers should note that, not all capital losses can be set off against capital gains. There are tax rules governing capital loss setting off. Let us discuss each capital gain / loss case one by one.

Short Term Capital Loss in Equity Funds

Short term capital losses from equity funds can be set off against both short term capital gains from all asset types. These asset types can be another equity fund, debt funds, shares of companies, debenture, gold, real estate etc. The holding period definition for short term capital gains taxation differs from asset type to asset type. Short term capital gain / loss holding period for equity funds is 12 months, while that for debt funds is 36 months. So, if you have made a loss in an equity fund held for less than 12 months, you can set off the loss against profit made in a debt fund held for 2 years. The netting off applies against other asset types like shares, debentures, gold, real estate etc.

Short term capital losses from equity funds can also be set off against long term capital gains of all asset types, excluding equity funds and equity shares. Long term capital gains in equity funds and shares are tax free, so the question of setting off losses against it does not rise. However, if you have long term capital gains from debt funds or asset types, you can set off short term capital losses from equity funds against the long term capital gains. When setting off short term capital losses in equity funds against long term capital gains of other asset types, do not subtract the capital loss from the gain because the tax rates are different for different asset types; calculate the tax payable on long term capital gains and the tax credit due to the capital loss. The difference between the tax payable and the tax credit is your tax obligation.

Long Term Capital Loss in Equity Funds

Long term capital gains from equity funds are tax free and therefore, you cannot claim any tax benefit for long term capital loss in equity funds. In other words, long term capital loss in equity funds cannot be set off against either short term or long term capital gains of any asset.

Short Term Capital Loss in Debt Funds

Short term capital losses from debt funds can be set off against both short term capital gains of all asset types. These asset types can be equity fund, debt funds, shares of companies, debenture, gold, real estate etc. So you if have made a loss in an debt fund held for less than 36 months, you can set off the loss against profit made in a equity fund held for less than a year. Short term capital losses from equity funds can also be set off against long term capital gains of all asset types, excluding equity funds and equity shares.

Long Term Capital Loss in Debt Funds

Long term capital losses from debt funds can be set off against long term capital gains of all asset types, excluding equity funds and equity shares. Suppose you have made a long term capital loss of Rs 20,000 in a debt fund and a long term capital gains of Rs 50,000 in a Gold ETF. Let us assume that long term capital gains tax (@ 20.6% after indexation) for the Gold ETF is Rs 6,000. Further assume that tax credit for the debt fund loss is Rs 1,000. Therefore, your tax obligation will be Rs 5,000 only.

Long term capital losses from debt funds cannot be set off against short term capital gains. For example, if you have made Rs 20,000 long term capital loss in a debt fund and Rs 20,000 short term capital gain in an equity fund. You will not be able to set off the loss and will have to pay 15.45% short term capital gains tax on the equity funds profit and your tax obligation will be Rs 3,090.

Loss Carry Forward

If your capital gains are not able to fully absorb the loss (in other words, loss is more than profit), you can carry-forward the loss to the next financial year and set off against future profits. Such carry-forward can be done for 8 years maximum. Please recall, however, that long term capital loss from equity funds cannot be carried forward because it cannot be set off against short term or long term profits.

Capital Loss after receiving dividends

We had earlier said that, capital gains / losses are calculated by subtracting NAV on purchase date from NAV on redemption (sale) date. Some investors buy equity mutual fund units based on information from their sources or market rumours that the Asset Management Company will declare a large dividend shortly. Equity mutual fund dividends are tax free as per Income Tax Act. Since, the dividends are declared from the assets of the scheme the NAV (price) falls after dividends are paid. The investor then redeems (sells) the units of the fund with a view to claim short capital loss in his IT return. This practice is known as dividend stripping. To prevent tax avoidance through dividend stripping, capital loss set off is not allowed under Income Tax Act, if investment was made within 3 months of dividend record date or redemption was made within 9 months of the dividend record date.

Conclusion

Nobody wants to make a loss in an investment. However, Income Tax Act allows you to use a loss to reduce your tax obligation. Investors should note that, capital loss cannot be set off against income from other heads. In this post, we have discussed how you can use losses to reduce your tax obligation for profits from other investments, within the rules of Income Tax Act. If you have made a loss, you can set off against profit made in the same financial year or carry forward the loss to the next year.

Article from www.Advisorkhoj.com

(Article written on behalf of Sundaram Mutual Fund)

Equity Outlook

- The month was riddled with volatility-inducing news flows from the Trump administration and Trump-tweets.
- On the domestic front, apart from the broad concerns around the budget in February, the space saw the obstacles to the GST clearing way.
- The Indian markets saw a marginal net outflow of $(0.4)bn. in January.

Global

- While global developed markets returns appeared fairly muted on the back of dollar weakness, the emerging market pack appeared to show some strength especially in the second half.
- The Indian markets saw strong positive moves in the run up to the budget; that continued even after.
- The global space was dominated by Trump announcements post his assuming Presidency on the 20th of January, when he started delivering the announcements he had promised in the run-up to his presidency.
- While his comments on the pharmaceutical space did make some noise, his executive orders on suspending US' refugee program and banning of citizens from majority Muslim dominant countries created quite a stir.
- On the macro front, US saw continued labour and manufacturing strength, alongside inflation.

Central banks

- The central banking space was fairly quiet during the month. End 2016 saw the start of a shift in trade towards Developed markets (DM), a strong dollar and rising yields. January saw all of these pause for a bit.
- Macro prints in both the US and Eurozone appear encouraging with headline inflation seeing a pickup; though energy related for now.
- The Federal Reserve's (Fed.) rate rise of December last year continues to give a confirmation to the markets on the direction of US growth. From a broad Emerging Market (EM) perspective, the Fed. event is a confirmation of US growth and a restriction of accommodative space for the EMs going forward.
- With a likely playout of easing fiscal stance in DMs, the bond space would be in focus and is set to see a gradual increase in yields.

Domestic

- The month saw the markets keenly looking out for what the budget had in store.
- RBI removed the cash limits on current accounts that were imposed during the phase of demonetisation. While the limits on savings accounts continue, this incremental development was a relief and a sign of normalisation.
- The GST council arrived at a consensus on key issues that were a hindrance to the GST roll out, including the agreement on dual control.
- On the macro front, CPI continued to soften on the back of food and tax growth was seen to hold strong.
- Industrial production saw a surprise surge in growth that was related to base effects.

Outlook

- In this year too, we expect the RBI to continue being supportive of growth. We see some more monetary accommodation from the central bank before bottoming out on the policy rate.
- The Government's commitment to spur the infrastructure investment cycle is already reflecting in improved execution on the ground. The budget continues to reflect this bias alongside consumption-supportive spends.
- The rural economy is in focus again, similar to what was seen in the last budget. This will help broad-basing growth and serve as political support during times of state elections.
- The stress in the banking system is expected to see more targeted addressing, with recognition, provision of bad loans and subsequent capitalisation commitments.
- The Government's demonetisation drive has resulted in a kind of demand shock across many sectors, though short term. The system is adjusting to the demonetisation move and the gradual shift towards a low-cash economy. We expect the economy to be back on track by Q4 of the year spurred by improved velocity of new currencies.
- While one may be concerned about the soft earnings growth seen, the quarterly results in January shows that the economy is quite resilient.

Conclusion

- After the December rate rise, the Fed. is likely to move ahead gradually, keeping in mind not to pull down economic growth that has just seen some momentum.
- 2017 is likely to be the year of the fiscal with most governments acknowledging the need to create demand through fiscal spending. India will not be far behind in this move and will continue to remain prudent in such deficit spending.
- With local demand shocks from demonetisation effects, markets could continue to be in a consolidation phase in the first quarter of the year and normalise as it sees the inherent resilience in the system.
- Valuations are much more attractive across many sectors and market segments offering comfort.
- With the with the twin deficits well contained, inflation well under control, bottomed out growth, a relatively stable currency and an extremely strong political mandate, every point of volatility would be an opportunity to buy India.
- We continue to remain positive on our equity markets with a medium to long term outlook.

Equity Desk

Debt Outlook

Debt markets

- RBI in its sixth bi-monthly policy decided to maintain status quo on rates, which was contrary to market expectations. However, the actual surprise was the change in RBI's monetary policy stance from accommodative to neutral. This resulted in sharp sell-off in bonds and yields on 10yr Government benchmark security moved up by 32bps by end of trading.
- The bonds remained well bid during the month, due to unprecedented liquidity with banks post demonetization and hopes of rate cut by RBI. However, hopes crashed on announcement of status quo by RBI. The 10 year G-sec yield traded in the range from 6.36% to 6.48% during the month and closed the month at high of 6.43%.
- Liquidity continued to improve during the month as banks continued to get huge deposits on account of demonetization. Liquidity was positive in the month of January with an average of around INR 2.0 trillion vs INR 1.6 trillion in December. RBI had to use term reverse repos and CMB's to suck out the excess liquidity in the banking system.

Domestic Macro Factors

- Industrial production (IIP) grew by 5.70% in November vs decline of 1.80% y-o-y in October, much steeper than market expectation of rise of 1.50%.
- India's external trade deficit narrowed to USD at $ 10.4 bn in December vs. 13 bn in November. This decline in deficit was due to pick-up in non-commodity exports and a decline in imports.
- INR traded in the range of 68.33 to 67.86 during the month and finally closed the month at 67.87/$ vs 67.92/$ in December appreciating by 0.1%.
- India's forex reserves are close to at $361.56 bn in the week ending January 27, 2017.

Inflation

- Headline CPI inflation decelerated to 3.4% y-o-y in December from 3.6% in November, largely due to lower food prices. This was marginally lower than market expectation of 3.5%.
- WPI inflation accelerated to 3.39% in December from 3.15% in November, this was also marginally lower than market expectation of 3.50%.

Outlook

- Domestically, the focus shifted from effects of demonetization on the economy to Govt. of India Budget of 2017-18 and last Bi-monthly Monetary policy of this Financial year.
- The Government budgeted to reduce the fiscal deficit to 3.2% of GDP in FY 2018 from 3.5% of GDP in F2017 .This indicates that policymakers are staying on a path of fiscal consolidation.
- The estimated Net borrowing stands lower at 63.7% of Fiscal deficit Vs 65% in FY 2017.
- Overall, the quality of fiscal consolidation is improving as revenue expenditure is expected to edge lower compared to capital expenditure.
- Further comforting is the new fiscal roadmap that requires the government to focus on debt. It requires the Government debt to be lowered to 60% of GDP by 2023 compared with 66% currently.
- The Monetary Policy Committee's decision to maintain status quo, much against the market consensus of 25 bps rate cut, led to sell off in bond markets. The real spoiler was MPC's decision to modify its stance from accommodative to neutral. MPC is concerned about global commodity prices and core inflation being rigid, thereby limiting the scope for headline inflation easing.
- Inflation is projected in the range of 4 - 4.5% in the first half of FY18 and in the range of 4.5 to 5% in the second half of FY18.
- We have been cognizant of the shrinking room available to RBI for further easing of monetary policy. Now with the change in stance, our view that the economy is nearing the end of rate cut cycle is ratified .The assessment of positive inflation path alone may not give space to RBI to cut rates due global risk environment. Even inflation which has been benign till now may see a surge if crude and global commodity prices see resurgence. This along with sticky core inflation limits the ability of RBI to reduce the policy rate significantly.

We envisage that with volatility being the cornerstone in the coming year and looking at the risk reward payoff, the fixed income investor is better off in short to medium term funds with an accrual focus. The dynamic bond funds which are mandated to ride the volatility of the markets are also suitable for investors.

Fixed Income Desk

RBI keeps rates unchanged, changes stance to neutral; Rate easing cycle appears to be over

RBI keeps rates unchanged and exercises 'abundant prudence'; Monetary policy bottoming out

RBI kept all rates unchanged in its 6th Bi-monthly policy, surprising some segments of the markets that were expecting a cut. The governor mentioned that the Monetary Policy Committee (MPC) exercised 'abundant prudence' in keeping the rates unchanged. All the members voted unanimously in favour of keeping rates unchanged. The policy language saw continuity in their hawkish view on inflation. In addition to this, they appeared positive on the growth outlook on account of the transient effect of demonetisation. With this policy, rates appear to have bottomed out and FY18 is likely to see an extended pause on rates.

RBI's pause strengthens Monetary Policy Committee (MPC) credibility further

The 6th bi-monthly continued to remain credible, with continuity in both thought and language from the last policy. The view on inflation set with upside risks continues in this policy. In addition, there is an emergence of some confidence on growth and more clarity on the transient nature of the demonetisation episode.

RBI sees discretionary consumption to 'bounce back' and activity levels in cash intensive sectors to be 'rapidly restored'

With FY18 growth pegged at 7.4%, the RBI appears much more confident on growth. It comes across to have greater clarity on the transient nature of the demonetisation episode. As a result of this confidence, it expects a) discretionary consumption to 'bounce back, b) cash intensive sectors to see activity levels being 'rapidly restored', c) lower lending rates to boost consumption & investment and d) the government's capex focus and fiscal consolidation in the budget to contain inflationary impulses.

Normalisation of cash withdrawal limits to neutralise any perceived demonetisation impacts into FY18

There has been a great amount of uncertainty around the impact of demonetisation on growth. This demonetisation overhang on growth was expected to continue well into FY18. However, the RBI's announcement to normalise cash withdrawals from the 13th of March appears to completely remove this perceived overhang in our opinion. So growth projections for FY18 would likely return to the same as they were pre Nov 8th 2016. From this stand point, one could clearly argue for more upside surprises to the RBI's FY18 growth projection of 7.4%.

Inflation clearly seen with upside risks, hinting at the end of the rate easing cycle

The 6th bi-monthly continues to emphasise the upside risks it observed in its 5th bi-monthly. While the RBI acknowledges the global uncertainties to continue, it notes three significant upside risks to the inflation path: a) hardening oil prices b) exchange rate volatility and c) HRA impacts of the 7th pay commission that have not yet been factored into the inflation trajectory of the central bank. With such upside risks globally and domestically, the rate easing cycle appears to have ended for now; with FY18 to see an extended pause.

Arjun G Nagarajan

Senior Economist - Sundaram Mutual

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Sundaram Asset Management Company Limited
Corporate Office: 2nd Floor, Sundaram Towers, 46, Whites Road, Royapettah, Chennai -14. Contact Number 1800 103 7237 (India) 044 4083 1500 (NRI)
Regd. Office: No. 21, Patullos Road, Chennai 600 002 CIN: U93090TN1996PLC034615 Fax: +91 44 2841 8108 www.sundarammutual.com

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