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FINANCIAL WISDOM 2017 MIP

# Look Before You MIP

## A smart investor should steer clear of monthly income plan (MIP) mutual funds and opt for a SWP-based strategy instead

By Aniruddha Bose

IF YOU HAVE just come into a lump sum of money and need to generate a monthly income from it, pause before you reflexively reach out for an MIP or monthly income plan mutual fund. There is a better option available.

The term MIP, suggestive of an assured monthly income, is a misnomer of sorts. MIPs do not guarantee or assure a fixed quantum of cash flow each month, but rather aim to provide it on a "best efforts" basis.

In effect, an MIP is a hybrid mutual fund that splits its corpus between equity and debt instruments, leaning heavily towards the latter. "Equities are volatile, and combining it with a fixed income portfolio reduces volatility," says Avnish Jain, Head of Fixed Income, Canara Robeco Asset Management Company.

Even aggressive MIPs usually do not exceed an equity allocation of 25 per cent, whereas conservative ones expose just about 15 per cent of their fund value to the vagaries of the stock markets. Thus, aggressive MIPs typically outperform their more cautious cousins by a couple of percentage points in the long run, albeit with higher volatility.

When investing into an MIP, investors can opt for the monthly dividend (MD), quarterly dividend (QD) or growth (G) option. The actual quantum of dividends paid out as income will vary from time to time, based on the performance of the underlying portfolio.

Here is the problem: dividends from MIPs, though tax-free in your hands, are taxed at source at a discomfortingly high rate of 28.33 per cent. In fact, that is the norm for all dividends arising from mutual funds that are debt-oriented. For every Rs 100 of MIP dividend declared by the fund house, you will receive roughly Rs 72 in your bank account.

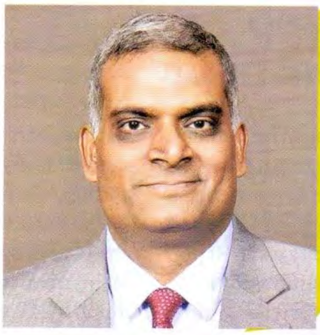
### MIPs: What to expect

To arrive at a reasonable estimate of what to expect from an MIP in terms of monthly income and capital appreciation, we evaluated the 10-year performance of the monthly dividend options for two top ranked aggressive MIPs: namely, Birla Sun Life MIP - II Wealth 25 and Kotak MIP.

In the past decade, both MIPs declared dividends in most months (86 per cent and 90 per cent of months, respectively), with the average pre-tax dividend amount on an investment of Rs 1 crore standing at Rs 47,537 a month for Birla Sun Life MIP-II Wealth 25 and Rs 40,210/month for Kotak MIP.

Both funds witnessed severe capital erosion during the market crash of 2008. Also, worth noting is the wide variance in the annual dividend pay-out amounts for both MIPs; the cumulative annual dividend for an investment of Rs 1 crore ranged between Rs 3.62 lakh and Rs 8.13 lakh for Birla Sun Life MIP – II Wealth 25 and between Rs 1.09 lakh and Rs 7.05 lakh for Kotak MIP.

Even under the optimistic assumption that MIPs will provide annual dividend yields in the range of 6 per cent in the foreseeable future, we are looking at a net dividend yield of



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just 4.3 per cent per annum after factoring in DDT (dividend distribution tax); an average in-hand monthly income of just Rs 35,585 on a sizeable deployment of Rs 1 crore. The unpredictability of the actual dividends only stands to exacerbate the issue!

### Synthetic "Dividends" using SWPs: A Superior Option

Fortunately, there is a better solution in sight; although it would require some work on your part. Under this approach, you will need to combine an equity fund, a debt fund, and a liquid fund; in effect, crafting your own MIP. Thereafter, initiate a systematic withdrawal plan (SWP) from the liquid fund, which will serve as a funnel for your monthly cash flows. "Most people choose the SWP facility instead of investing in the dividend option, since dividends are not certain in terms of periodicity and quantum," observes Jain.

The SWP would lead to an automatic sale of liquid fund units on a fixed date each month, creating an income stream for you to consume. At the end of each year, you will need to replenish the "funnel" by switching a fixed sum of money from the debt fund to the liquid fund, and reinitiate the SWP thereafter. The equity fund should be held on to for a minimum duration of five years.

Broadly speaking, there are three advantages to this approach. First, your tax burden will be significantly reduced. Indeed, short-term capital gains will arise from the sale of debt fund and liquid fund units every year, but these will be miniscule when compared to the hefty DDT burden associated with MIP dividends. Second, you'll have the luxury of selecting top performers from the universes of debt and equity funds; giving yourself a shot at achieving higher returns. A third, lesser visible benefit would be the tax-free profits arising from the sale of equity fund units when you choose to liquidate your investments; had you instead booked capital gains from an MIP, the entire profit would have been taxable as capital gains. In 2017, investment-income aspirants would certainly be taking a smart decision by steering clear of MIPs and opting for an SWP-based strategy instead. BW