OMEGA PORTFOLIO ADVISORS

Investing in Fixed Income

The Foundation of a Well-Balanced Investment Portfolio

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Introduction

When people think of investing, they usually think of equities. After all, equities have historically been the sought after asset class for creating long-term wealth.

Yet, no successful portfolio is built on equities alone.

Every investor has money that will be needed at different points in life. Some may be required in the next few months, some over the next few years, while the rest can remain invested for decades. Treating all of it the same way, regardless of when it will be needed, exposes you to unnecessary risk.

This is where Fixed Income plays an essential role.

Fixed Income is often misunderstood as merely "safe investments" that deliver lower returns than equities. In reality, its purpose is far more important. It ensures the portfolio is in a comfortable range of volatility, ensures money is available when it is needed, generates predictable income and allows the equity portion of your portfolio to remain invested through market cycles.

In other words, equities help you build wealth. Fixed Income helps you protect it and use it when you need it.

The objective of Fixed Income is therefore not to maximise returns. It is to improve the overall behaviour of your portfolio by balancing growth with stability and ensuring that each part of your wealth serves a specific purpose.

At Omega, we do not view Fixed Income as a separate investment decision. We view it as an integral part of your asset allocation. The amount you invest, the type of Fixed Income instrument you choose and the duration for which you invest all depend on your financial goals, cash flow needs, risk capacity and investment horizon.

This guide will help you understand:

- Why every investor needs Fixed Income, regardless of age or wealth.
- The different Fixed Income investment options available in India.
- How interest rates influence returns.
- How to choose the right Fixed Income investments for different goals.
- How Fixed Income complements equities to create a more resilient portfolio.

By the end of this guide, you should be able to look beyond individual products and understand how Fixed Income fits into a disciplined investment strategy designed to help you achieve your financial goals with greater confidence.

Chapter 1. Why Every Investor Needs Fixed Income

One of the most common questions investors ask is:

"If equities generate higher returns over the long term, why should I invest in Fixed Income at all?"

It is a reasonable question.

If your objective were simply to maximise long-term returns, you would naturally allocate as much as possible to equities. But investing is not only about maximising returns. It is about achieving your financial goals with the highest possible probability of success.

That requires balancing growth with certainty.

Investing Is About More Than Returns

Imagine two investors.

The first has invested every rupee in equities because they offer the highest expected return.

The second has allocated most of their long-term wealth to equities but has also kept money needed over the next few years in appropriate Fixed Income investments.

During a market correction, both portfolios decline. A few months later, the first investor needs money for a child's education or the purchase of a home. Since all the money is invested in equities, they have no choice but to sell investments at depressed prices.

The second investor, however, draws the required money from the Fixed Income portion of the portfolio, allowing the equity investments time to recover.

Although both investors owned the same equities, only one was forced to convert temporary market volatility into a permanent loss.

The difference was not stock selection.

It was asset allocation.

The Role of Fixed Income

Fixed Income performs four important functions within a portfolio.

1. Ensures You Have the Capital to Meet your Goals When They Come

Money required over the next few months or years should not be exposed to the volatility of equity markets.

Even the strongest businesses experience periods when their share prices decline significantly. If you are forced to sell during one of these periods, you may permanently impair your capital.

Fixed Income provides greater certainty that money will be available when it is required.

2. Reduces Overall Portfolio Risk

Equity markets are inherently volatile. While this volatility is the price investors pay for superior long-term returns, not every part of your portfolio needs to experience it.

A well-constructed Fixed Income allocation acts as a stabiliser. It keeps the whole portfolio's swings inside a comfortable range and makes it easier to remain invested through market cycles instead of reacting emotionally to short-term movements.

3. Provides Liquidity

Life rarely follows a predictable timetable, and both emergencies and opportunities arrive without notice.

Having an appropriate allocation to highly liquid Fixed Income investments means you do not have to sell long-term equity investments simply because cash is needed immediately.

Liquidity provides flexibility, and flexibility is an important component of financial security.

4. Generates Predictable Income

For investors approaching retirement or those who depend on their investments for regular cash flows, predictability becomes more important than maximising returns.

Fixed Income investments provide a relatively stable stream of income, making them an important component of retirement planning and income-oriented portfolios.

The Cost of Ignoring Fixed Income

Many investors assume that being aggressive means investing entirely in equities.

In reality, this often increases risk rather than returns.

Markets do not fall according to your financial plans. They may decline just before you need money.

This is known as sequencing risk, the risk that adverse market returns occur immediately before you need to withdraw your investments. Even if markets recover later, that recovery offers little comfort if you have already been forced to sell.

One of the most effective ways to manage sequencing risk is to ensure that money needed over the next three to five years is invested in appropriate Fixed Income instruments rather than equities.

Fixed Income Is Not a Replacement for Equities

Understanding the role of Fixed Income is just as important as understanding its limitations.

It is not intended to replace equities as the primary engine of long-term wealth creation. Over long periods, high-quality equities have historically generated superior returns because they participate in the growth of businesses and the economy.

Fixed Income serves a different purpose.

Its job is to preserve capital, provide liquidity, support future cash-flow needs and make the overall portfolio more resilient.

Trying to make Fixed Income behave like equities by chasing the highest yields usually means taking additional interest-rate or credit risk without fully appreciating the consequences.

Think of Your Portfolio as a Team

A successful cricket team does not consist entirely of batsmen.

Each member performs a different role, and together they produce a stronger outcome than any individual part could achieve on its own.

Your investment portfolio works in much the same way.

Equities create long-term growth.

Fixed Income provides stability, liquidity and certainty.

Neither is sufficient on its own. Together, they significantly improve the likelihood of achieving your financial goals.

Chapter 2. Understanding Fixed Income

Most people are familiar with Fixed Deposits, but far fewer understand what they actually represent.

Whether you invest in a bank Fixed Deposit, buy a Government Security, invest in a Corporate Bond or choose a Debt Mutual Fund, the underlying principle is the same.

You are lending money.

Instead of becoming an owner of a business, as you do when you invest in equities, you become a lender. The borrower could be the Government of India, a State Government, a bank or a company. In return for lending your money, the borrower agrees to pay you interest and return your principal at a specified date.

That is why this asset class is called **Fixed Income**.

Unlike equities, where returns depend on how well a business grows over time, Fixed Income investments are designed to provide greater predictability. The return you ultimately earn depends primarily on the interest rate at which you lend, the quality of the borrower and the period for which your money is committed.

The Different Ways to Invest

Indian investors today have several Fixed Income options available to them.

Some involve lending directly to the borrower, while others invest through professionally managed funds.

The most common options include:

- Bank Fixed Deposits
- Government Securities (G-Secs)
- Treasury Bills
- State Development Loans (SDLs)
- RBI Floating Rate Savings Bonds
- Corporate Bonds
- Debt Mutual Funds
- Target Maturity Funds

Each of these serves a different purpose.

Some are ideal for parking money for a few months. Others are better suited for medium-term goals. Some provide greater certainty, while others seek to improve returns by taking carefully managed interest-rate or credit exposure.

Choosing between them should never begin with the question:

"Which one gives the highest return?"

Instead, the right questions are:

- When will this money be needed?
- How much certainty do I need?
- How important is liquidity?

Once these questions are answered, the appropriate Fixed Income investment becomes much easier to identify.

Understanding Return

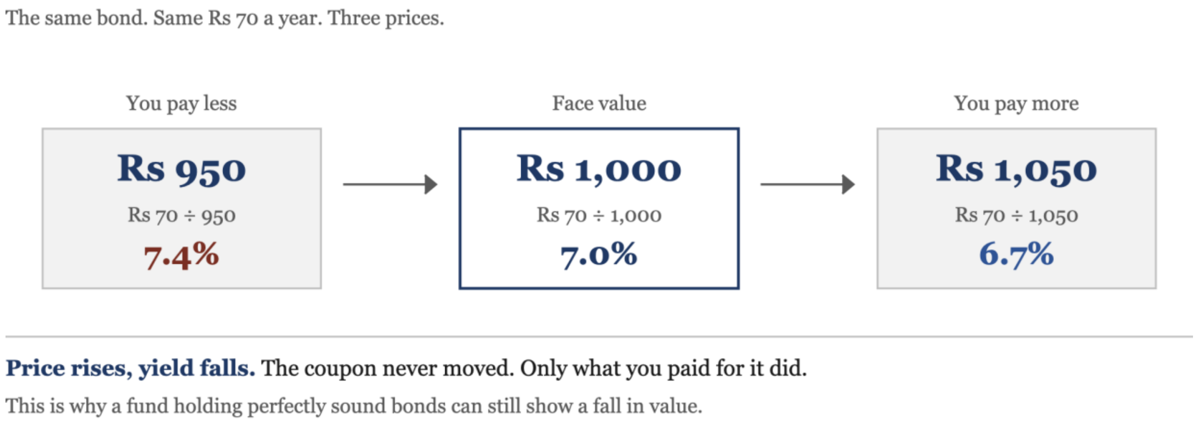


Figure 1. Price and yield move in opposite directions.

One of the biggest misconceptions about Fixed Income is that the stated interest rate is always the return an investor earns.

In reality, the return depends on the price at which the investment is purchased.

Imagine a bond that pays ₹70 every year on a face value of ₹1,000.

If you buy it for ₹1,000, your yield is 7%.

But suppose market interest rates rise and you are able to buy the same bond for ₹950. The annual interest remains ₹70, but because you paid a lower price, your effective return is now higher.

Conversely, if interest rates fall and investors are willing to pay ₹1,050 for the same bond, the yield reduces.

This is why bond prices and interest rates always move in opposite directions.

When interest rates rise, existing bonds become less attractive and their prices fall.

When interest rates fall, existing bonds become more valuable and their prices rise.

This relationship explains something that surprises many investors.

A Debt Mutual Fund invested entirely in high-quality Government Securities can sometimes show a temporary negative return.

That does not necessarily mean any borrower has defaulted.

It simply reflects the fact that the market value of the underlying bonds changes as interest rates move. If those bonds continue to pay interest and are held until maturity, this temporary price movement gradually becomes less significant.

Understanding this distinction is one of the keys to becoming a confident Fixed Income investor.

Chapter 3. Understanding the Risks in Fixed Income

Many investors believe Fixed Income investments are "risk free."

They are not.

They are generally less volatile than equities, but they are exposed to different kinds of risk. Understanding these risks is far more important than memorising the different products available in the market.

Every Fixed Income investment involves a balance between return, certainty and flexibility.

Higher returns are almost always accompanied by taking more of one particular risk.

The first step towards making better decisions is understanding what those risks are.

1. Interest Rate Risk

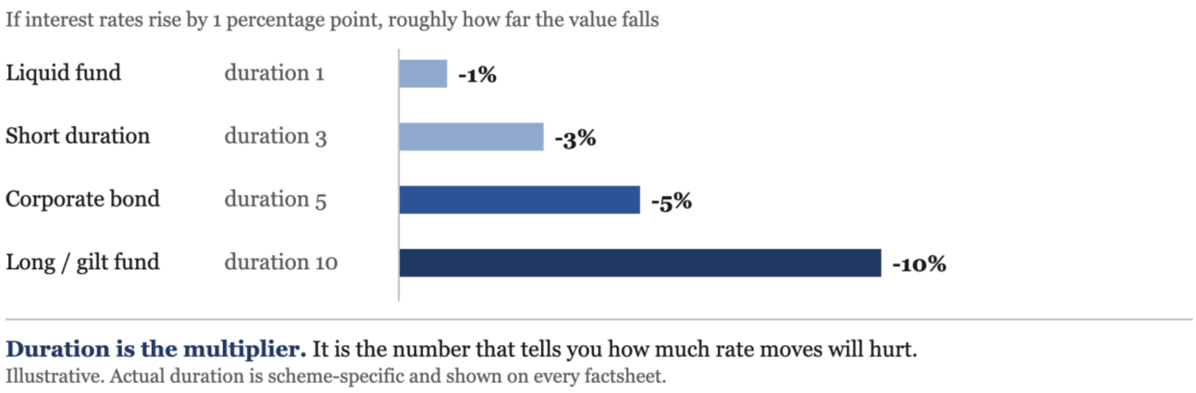


Figure 2. Duration is the multiplier on interest-rate risk.

Interest rates in the economy do not remain constant.

They rise and fall depending on inflation, economic growth and the Reserve Bank of India's monetary policy.

Chapter 2 explained why this moves the price of a bond that has already been issued. What matters here is how much it moves.

The longer the maturity of a bond or fund, the greater its sensitivity to changes in interest rates.

This concept is known as duration, and it is one of the most important factors in Fixed Income investing. Longer-duration investments experience larger price movements, while shorter-duration investments tend to be much more stable.

2. Credit Risk

Whenever you lend money, there is always the possibility that the borrower may fail to repay it.

This is known as credit risk.

The Government of India is generally regarded as having the lowest credit risk because it has the power to raise taxes and issue currency.

Banks and highly rated companies also have relatively low credit risk.

Lower-rated companies, however, must offer higher interest rates to compensate investors for accepting a greater possibility of delayed payments, downgrades or default.

This is why a bond offering a significantly higher yield than comparable investments deserves careful scrutiny.

A higher yield is usually not a free lunch.

It is compensation for taking greater risk.

3. Reinvestment Risk

At first glance, earning your money back sooner appears to be an advantage.

But it creates another challenge.

Suppose you invest for one year when interest rates are 7%.

If interest rates fall to 5% when your investment matures, you must now reinvest at the lower rate.

Your future returns decline even though your original investment performed exactly as expected.

This is known as reinvestment risk.

Ironically, the investments that are least sensitive to rising interest rates often face the greatest reinvestment risk when rates begin to fall.

4. Liquidity Risk

Liquidity refers to how easily an investment can be converted into cash without significantly affecting its value.

A bank Fixed Deposit can usually be broken before maturity, though often with a penalty.

Government Securities can be traded in the market, although retail trading volumes may be limited.

Some corporate bonds may not have active buyers when you wish to sell them.

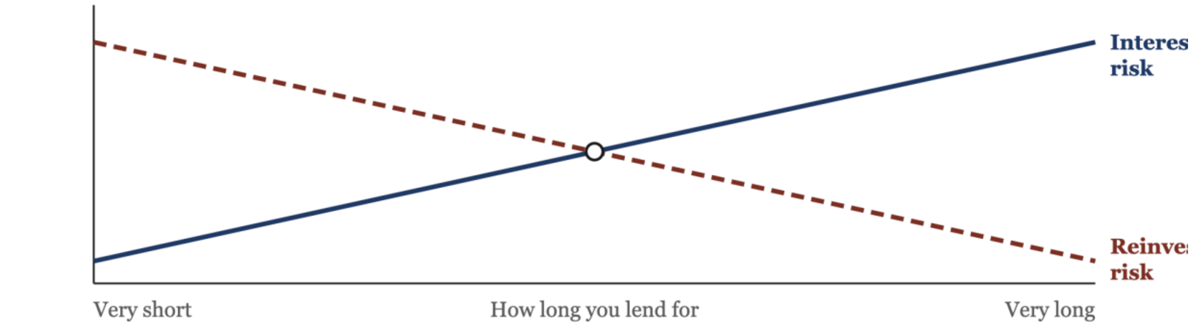
Similarly, certain Debt Mutual Funds that invest in lower-rated securities can experience liquidity pressures during periods of market stress.

Although these situations are uncommon, they remind us that not every Fixed Income investment offers the same level of access to money.

Liquidity should therefore be considered before investing, particularly if the money may be required unexpectedly.

Every Risk Has a Trade-Off

Shortening duration does not remove risk. It swaps one risk for another.



There is no point on this line with no risk. Which one you accept is decided by when you need the money, not by which risk sounds worse.

Figure 3. Shortening duration swaps one risk for another.

One of the most important lessons in Fixed Income investing is that no investment eliminates every risk.

Reducing one type of risk often increases another.

Keeping money in very short-term investments reduces interest-rate risk but exposes you to reinvestment risk if interest rates decline.

Extending the maturity of your investments allows you to lock in current interest rates for longer, but increases sensitivity to future interest-rate movements.

Similarly, seeking higher yields usually means accepting greater credit risk.

There is no universally "best" Fixed Income investment.

The right choice depends on the purpose of the money that you have invested in a specific Fixed Income product, the time for which it can remain invested and the degree of certainty you require.

That is why successful Fixed Income investing begins with your financial goals rather than with a search for the highest return.

Chapter 4. Choosing the Right Fixed Income Investment

Once you understand the role of Fixed Income and the risks involved, the next question is naturally:

"Which Fixed Income investment should I choose?"

Most investors begin by comparing products.

"Should I invest in a Fixed Deposit?"

"Are Debt Mutual Funds better?"

"Should I buy Government Bonds?"

These are understandable questions, but they start at the wrong place.

The right investment is not determined by the product. It is determined by what you need the money for and by when.

The same investor may need several different Fixed Income investments because each serves a different purpose.

Rather than thinking about products, think about your money in different buckets.

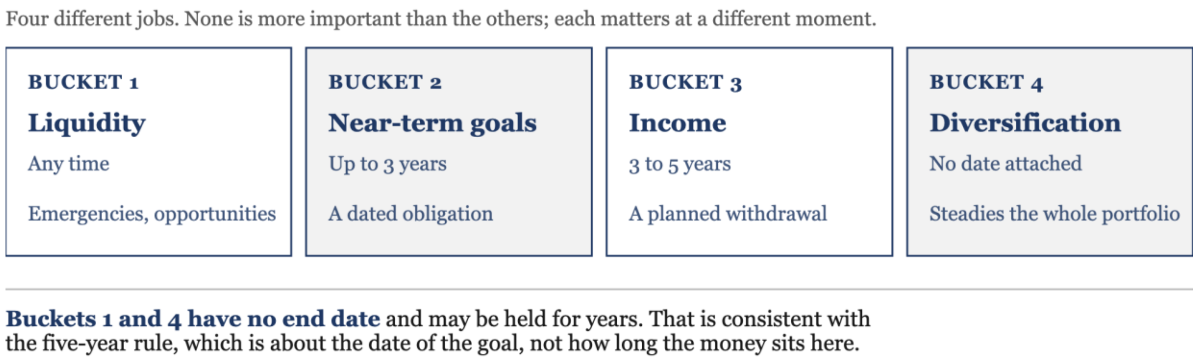


Figure 4. The four buckets, of equal standing.

Bucket 1 – Money You May Need Anytime

Every investor should have money that is available immediately.

This is your emergency fund or cash reserve.

It is meant for unexpected medical expenses, temporary loss of income, urgent family needs or simply to avoid selling long-term investments when markets are down.

Even for opportunities that arrive out of the blue, you need the capital ready to take advantage of it.

Safety and liquidity are the priorities here.

Returns are secondary.

Suitable investments include:

- Savings Accounts
- Liquid Funds
- Overnight Funds
- Very Short-Term Deposits

The purpose of this bucket is not to grow wealth.

It is to provide peace of mind.

Bucket 2 – Money Needed Over the Next Few Years

Suppose you are planning to buy a house in two years.

Or your child's college fees are due in three years.

Or you know you will need capital for your business in 1.5 years.

These are important financial goals, and should not be exposed to the volatility of equity markets.

The closer a goal gets, the less risk you should take with that money.

Suitable investments typically include:

- Short Duration Debt Funds
- Money Market Funds
- Low Duration Funds
- Fixed Deposits
- Treasury Bills for shorter periods

These investments aim to preserve capital while earning a reasonable return over the investment period.

The objective is not to maximise returns.

It is to maximise certainty of receiving the money back as per the goal's timeline.

Bucket 3 – Investment that Provides You A Steady Source of Income

Some investors require a portion of their portfolio to generate relatively stable income while accepting moderate fluctuations in value.

This part of the portfolio can invest in instruments with somewhat longer maturities, still inside the five-year horizon, ensuring capital preservation while drawing on income as per the requirement and for a pre-decided time period

Examples include:

- Medium Duration Debt Funds
- Target Maturity Funds

Because these investments generally have longer maturities, their values can fluctuate more when interest rates change. However, investing in these funds with a fixed withdrawal amount in mind allocates for that.

Bucket 4 – Diversification

A set amount of your entire portfolio, invested in Fixed Income to ensure that your overall portfolio has a limited and comfortable range of volatility.

Investors who are not invested for diversification may see their portfolio rise and fall together with nothing ensuring that the volatility is kept in check.

Investment products for the same can change based on preference, risk appetite and profile, as well as overall portfolio allocation across asset classes.

The Most Important Principle: Match the Investment to the Time Horizon

Figure 5. The horizon ladder, and the five-year rule.

One simple principle can help investors avoid many costly mistakes.

The time for which you can remain invested should determine the type of Fixed Income investment you choose.

As a general guide:

If you need the money in...	Consider...
Less than 6 months	Savings Account, Liquid Fund, Overnight Fund
6 months to 3 years	Low Duration, Money Market or Short Duration Funds, FDs
3 to 5 years	Corporate Bond, Banking & PSU, Medium Duration Funds, Target Maturity Funds
More than 5 years	Equity

Notice that this framework is based entirely on **when the money will be needed**, not on what interest rates are expected to do.

That is intentional.

Your financial goals, requirements and the timeline of those should determine your investment strategy.

Market forecasts should only influence small tactical decisions within that strategy.

Debt Mutual Funds or Fixed Deposits?

Many investors believe this is an either-or decision.

It is not.

Both have a place in a well-constructed portfolio.

A Fixed Deposit provides certainty. You know the interest rate, the maturity date and the amount you will receive if you hold it until maturity.

Debt Mutual Funds offer something different.

They provide access to professionally managed portfolios across a wide range of maturities and issuers. They also offer greater flexibility in matching investments to specific time horizons and, in many cases, easier access to your money before maturity.

Neither is universally better.

The choice depends on the purpose of the investment.

If certainty of returns is the overriding objective, a Fixed Deposit may be appropriate.

If flexibility, diversification and better matching of investment duration to your financial goals are important, a suitable Debt Mutual Fund may be a better choice.

The question is never which product pays the most. It is which product suits the purpose this money is meant to serve.

Choosing the Right Investment Is Only Half the Decision

Selecting the appropriate category is only the first step.

Within every category, there are multiple investment options that differ in portfolio quality, maturity profile, credit exposure, costs and risk.

Two funds belonging to the same category can behave quite differently.

Similarly, two corporate bonds offering similar yields may have very different levels of credit risk.

Choosing the right investment therefore requires looking beyond the product label.

The next chapter explains what the main types of Debt Mutual Fund actually are, so that the names you will hear quoted stop being jargon.

Do not chase yesterday's best performer

One of the biggest mistakes investors make is choosing the fund with the highest recent return.

Unlike equities, today's best-performing debt fund may simply have benefited from a favourable interest-rate environment that may not continue.

In Fixed Income, suitability matters far more than past performance.

Chapter 5. Understanding Debt Mutual Funds

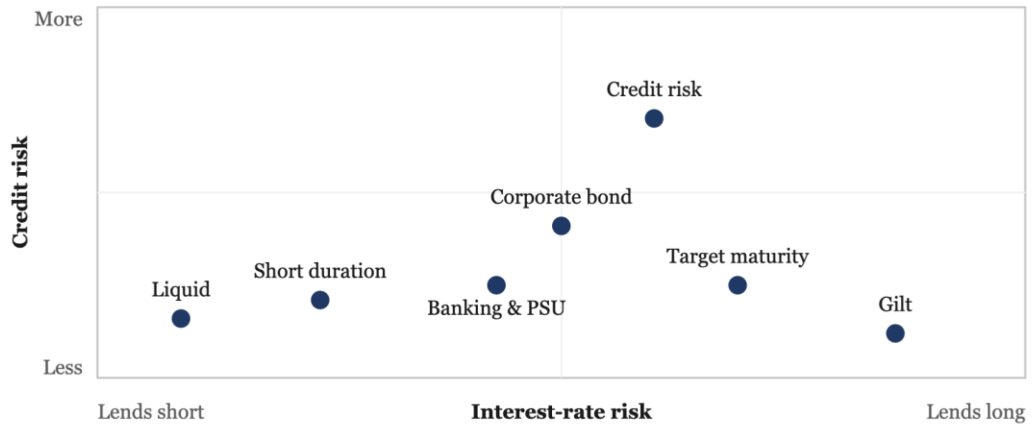
Debt Mutual Funds invest in a portfolio of Fixed Income securities such as Government Bonds, Treasury Bills, Corporate Bonds and Money Market instruments.

Unlike a Fixed Deposit, where you lend money to a single institution, a Debt Mutual Fund spreads your money across many securities and is managed by professional fund managers.

Not all Debt Mutual Funds are the same.

The biggest difference between them is **how long they lend money for** and **who they lend it to**.

The two risks that separate one debt fund from another



Gilt funds are the useful case. Almost no credit risk, because the government is the borrower. A great deal of interest-rate risk, because they lend for a very long time.

Figure 6. Where each category sits on the two risks.

Liquid Funds

Think of these as an alternative to keeping money in a savings account or very short-term deposit.

They invest in securities that mature within a few months and therefore experience very little fluctuation in value.

Best suited for: Emergency funds and money that may be needed at short notice.

Short Duration Funds

These funds invest in securities that mature over the next one to three years.

They aim to provide slightly better returns than Liquid Funds while still maintaining relatively low volatility.

Best suited for: Money required over the next few years.

Corporate Bond Funds

These funds primarily lend to high-quality companies.

The returns are generally higher than Government Securities because companies pay a slightly higher interest rate to borrow money.

Best suited for: Investors with a medium-term horizon seeking a balance between income and stability, at additional risk.

Banking & PSU Funds

These funds invest mainly in debt issued by banks, Public Sector Undertakings (PSUs) and government-backed institutions.

Because of the generally high quality of the issuers, they are considered relatively conservative.

Best suited for: Investors looking for good credit quality with moderate returns.

Gilt Funds

Gilt Funds invest only in Government Securities.

Since there is virtually no credit risk, many investors assume they are the safest debt funds.

But that is only partly true.

Although the Government is unlikely to default, the prices of long-term Government Bonds can fluctuate significantly as interest rates change.

So, Gilt Funds have very low credit risk but can have high interest-rate risk.

Target Maturity Funds

These funds invest in a basket of bonds that mature around a specific year.

The portfolio is designed so that, if held until maturity, the interest-rate fluctuations along the way become less important.

They combine the diversification of a mutual fund with the predictability of holding bonds to maturity.

Best suited for: Investors with a clearly defined future goal, that falls within the next five years, such as school or college fees.

Which Debt Fund Should You Choose?

It depends less on the fund than on when you need the money. The horizon table in Chapter 4 is the one to use; it applies to every product named in this chapter.

Don't worry about remembering every category.

Remember the principle:

Choose the Fixed Income investment that matches the time horizon of your goal, not the one that delivered the highest return last year.

That single principle will prevent most of the mistakes investors make in Fixed Income.

Chapter 6. The Most Important Decision in Fixed Income: How Much Should You Invest?

Most investors ask the wrong question.

They ask,

"Which debt fund should I invest in?"

The more important question is,

"How much of my portfolio should be in Fixed Income in the first place?"

The answer isn't found in market forecasts, interest-rate expectations or what someone else is doing.

It lies in **your life**.

Your Asset Allocation Should Reflect Your Financial Needs

Imagine four investors.

Investor A

A 30-year-old professional.

No dependents.

Stable income.

No major financial commitments for the next ten years.

Most of this investor's wealth can remain invested in equities because there is time to ride through market cycles.

Their Fixed Income allocation may only need to cover an emergency fund and a few near-term goals.

Investor B

A couple planning to buy a home in three years.

Although they have a long investment horizon for retirement, the money earmarked for the house should not be exposed to equity market volatility.

This goal deserves its own Fixed Income allocation, separate from the rest of the portfolio.

Investor C

Parents saving for a child's higher education in five years.

The closer the goal comes, the more important certainty becomes.

Even if equities appear attractive, gradually shifting this money into appropriate Fixed Income investments increases the probability that the funds will be available exactly when needed.

Investor D

A retired couple depending on their investments for monthly expenses.

For them, stability and regular cash flows are as important as long-term growth.

A much larger allocation to Fixed Income may therefore be appropriate, while equities continue to provide growth for future years.

Notice something interesting.

Each investor may own exactly the same equity funds and exactly the same debt funds.

What differs is **the proportion allocated to each.**

Don't Think in Percentages Alone

One may come across rules stating:

- Keep 40% in debt.
- Keep your age in debt.
- Always invest 60:40.

These can be useful starting points, but they should never replace thoughtful financial planning.

A 45-year-old entrepreneur with irregular income may need a very different Fixed Income allocation from a 45-year-old salaried executive with substantial pension benefits.

Similarly, two retirees with the same age may require very different portfolios depending on their lifestyle, expenses and other sources of income.

There is no universal formula.

Think in Buckets Instead

Chapter 4 set out four buckets. Sizing your Fixed Income allocation means deciding how much belongs in each of them.

Ask yourself:

How much must stay available at all times, for emergencies? How much is needed for goals falling within the next five years? How much must produce a regular income, and for how long? How much should sit in Fixed Income purely to keep the whole portfolio's swings inside a range you can live with? Once these questions are answered, your Fixed Income allocation begins to reveal itself naturally.

You are no longer trying to "invest in debt."

You are assigning every rupee a purpose.

Fixed Income Makes Equities More Powerful

Chapter 1 showed why, with two investors and one market correction: the one who held enough Fixed Income was never forced to sell equities at the wrong moment.

Fixed Income doesn't improve your portfolio because it earns spectacular returns.

It improves your portfolio because it gives your equities the **time** they need to create wealth.

That may be its greatest contribution.

Before Choosing Investments, Decide Their Purpose

The sequence is always the same.

1. Define your financial goals.
2. Estimate when each goal will require money.
3. Decide how much belongs in Fixed Income.
4. Only then choose the appropriate investment.

Investors who reverse this sequence often end up owning products they don't really need.

Investors who follow it build portfolios where every investment has a clearly defined role.

And that is the essence of successful asset allocation.

Chapter 7. How Fixed Income Actually Pays You

This chapter answers a question that is asked constantly and answered badly:

"If I put money in a debt fund, when does it pay me?"

The honest answer surprises most people.

A debt fund does not pay you a coupon. It has no promised payment date and no promised rate.

Understanding why is what separates an investor who is comfortable holding Fixed Income from one who is quietly confused by every statement.

What happens to the interest the bonds pay

The bonds inside the fund do pay interest, usually twice a year. That money goes to the fund, not to you.

When it arrives, the fund is worth slightly more than it was the day before. That shows up in the fund's price per unit, which is called the Net Asset Value, or NAV. You are not paid. Your units are simply worth a little more.

This is why a debt fund's value drifts upward on ordinary days with nothing happening. It is interest accumulating inside the fund. It is also why, as Chapter 3 explained, the same NAV can fall when interest rates move, even though every borrower is paying on time.

The three options you will be asked to choose between

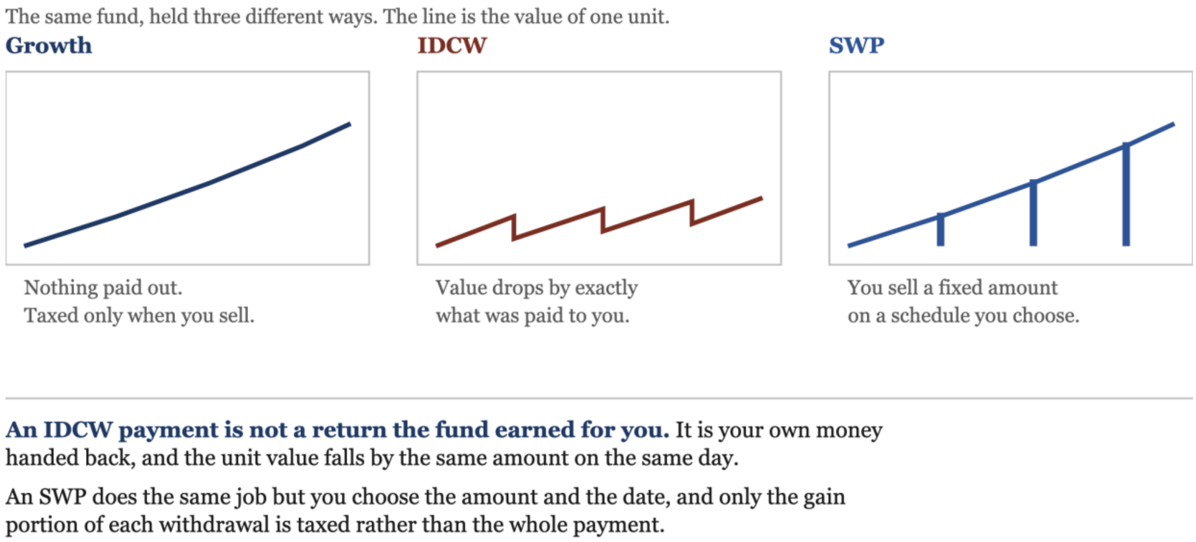


Figure 7. Growth, IDCW and SWP compared.

***NOTE**: SWP is NOT an option to choose from, you can choose an SWP plan to receive pre-defined amounts at regular intervals defined by you. It is NOT available as an investment option.*

Growth

Nothing is paid out. The number of units you hold never changes. Their value rises as interest accumulates. You realise a gain only when you sell, and you are taxed only then.

IDCW

IDCW stands for Income Distribution cum Capital Withdrawal. The name is deliberately unlovely, and it is worth reading it slowly, because it describes exactly what happens.

The fund pays you a sum. On the same day, the NAV falls by exactly what was paid. Your units are worth less by precisely the amount you received.

An IDCW payment is not income the fund earned on top of your capital. It is a withdrawal from your own holding, handed back to you.

Until April 2021 this option was called the Dividend option. It was renamed by the regulator because the old name led investors to believe they were receiving a return while their capital stayed intact. They were not, and it did not.

The amount is also at the fund's discretion. It is not a rate you can plan around.

The better way to draw an income

If you need money to arrive regularly, there is a cleaner mechanism: a Systematic Withdrawal Plan, usually shortened to SWP.

You instruct the fund to sell a fixed rupee amount of your units on a fixed date each month or quarter and send you the proceeds. You choose the amount. You choose the date. You can change or stop it.

It is also treated better for tax. When you redeem units, only the gain portion is taxable, not the whole amount, because part of what you receive is your own capital coming back. An IDCW payment is taxed on the full amount at your slab rate. The next chapter sets out how Fixed Income is taxed in full.

For anyone drawing a regular income from Fixed Income, an SWP from the growth option is usually the better structure than the IDCW option.

Why this matters for Bucket 3

Chapter 4 described Bucket 3 as the money that provides a steady source of income for a pre-decided period. It is now clear what that actually means in practice.

It does not mean the fund promises to pay you. It means you hold enough in an appropriate fund, and you set up a withdrawal that runs for as long as you have planned for. The regularity comes from the instruction you give, not from a promise the fund makes.

That is also why Bucket 3 is sized in years of expenses rather than as a percentage. You are not buying a yield. You are funding a defined number of withdrawals.

What none of this guarantees

No debt fund guarantees a rate of return, a payment, or the return of your capital. A fixed deposit does promise a rate, and bank deposits carry insurance up to a per-bank limit set by the deposit insurance regulator. A debt fund carries no equivalent.

That is not an argument against debt funds. It is the distinction that has to be understood before choosing one.

Chapter 8. What You Actually Keep: Tax and Cost

You do not spend returns. You spend what is left after tax and costs.

This matters more in Fixed Income than in equity. The returns are smaller to begin with, so a given amount of tax takes a larger share of them. A difference that looks trivial on paper can remove a meaningful part of what the investment was supposed to deliver.

This chapter explains how Fixed Income is taxed in India, what changed recently, and what it means for the choices in the earlier chapters.

The rule that changed everything

For many years, debt funds were sold partly on tax. If you held one for more than three years, the gain was treated as long term, and you were allowed to adjust your purchase price upward for inflation before calculating what you owed. That adjustment was called indexation, and it often reduced the taxable gain to very little.

That ended on 1 April 2023.

For any debt fund investment made on or after that date, the gain is added to your income and taxed at your own slab rate, however long you hold it. There is no indexation. There is no long-term treatment. The holding period no longer changes the answer.

For new money, a debt fund and a fixed deposit are now taxed the same way.

This is worth stating plainly because the older argument is still repeated. It is no longer true for a fresh purchase. Anyone recommending a debt fund on tax grounds today is working from a rule that no longer exists.

The one exception that still exists

Units bought before 1 April 2023 were not caught by the change. They kept a separate treatment, which was itself amended in July 2024. Held beyond twenty-four months, the gain on those older units is taxed at a flat rate rather than at your slab rate, without indexation.

This is the only remaining tax advantage in the category, and it is a closing pool. Nothing new can be added to it. Investors frequently do not know they hold such units, because nothing on a statement flags them.

Worth checking: any debt fund units bought before April 2023 are worth identifying before they are switched or redeemed, because switching resets them into the current regime.

What this means for the choice

If tax no longer separates a debt fund from a deposit, what does?

The reasons given in Chapter 4 still stand, and they were always the better reasons. A debt fund spreads your money across many borrowers instead of one. It lets you match the investment more closely to when you need the money. It is usually easier to access before maturity. A deposit gives you a known rate and a known date, which is worth a great deal when certainty is the point.

Choose between them on those grounds. Not on a tax advantage that has been withdrawn.

Costs, and why they bite harder here

Every mutual fund charges an annual fee, expressed as a percentage of the money you have invested. It is deducted from the fund's value rather than billed to you, so you never see it leave your account. That does not make it small.

In equity, a fee of a given size is a modest share of the expected return. In Fixed Income, where the gross return is lower, the same fee is a much larger share of it. This is the single most reliable way to improve a Fixed Income outcome, because unlike returns, the fee is known in advance and does not depend on what markets do.

Two versions of the same scheme are usually available. One is sold through a distributor and carries a commission inside the fee. The other is bought directly from the fund house and does not. The portfolio is identical. The difference goes to the investor.

The standing warning

Debt fund taxation changed in three consecutive budgets. Treat every rate in this guide as a starting point, not an answer, and verify against current Income Tax rules before you repeat it to anyone. Current rates are in Annexe B, with the date they were checked.

Chapter 9. How Omega Builds a Fixed Income Portfolio

INTERNAL SECTION. This chapter describes Omega's own process and internal thresholds. It is not part of any investor-facing version of this guide and should be removed before the document is shared outside the firm.

Everything up to this point has been written from the investor's side: what Fixed Income is, what it is for, and how to choose. This chapter describes how we translate those principles into an actual allocation.

It is placed last deliberately. The reasoning should be intelligible to a client without reference to our process. The process exists to apply the reasoning consistently, not to replace it.

Three tiers, not four

The allocation framework, after the five-year rule

TIER 1	TIER 2	TIER 3
Liquidity	**Near-term goals**	**Medium term, income**
0 to 6 months	6 months to 3 years	3 to 5 years

TIER 4, REMOVED

~~Long-duration and gilt, beyond 7 years. No horizon left to serve under the five-year rule.~~

Gilt and long-duration funds are still explained in Chapter 5, because the terms are in common use. They are not part of the allocation.

Figure 10. The allocation framework, with the removed tier shown.

Fixed Income is structured in three tiers by horizon:

- Liquidity, zero to six months. Overnight and liquid funds, savings balances. Judged on access, never on return.
- Near-term goals, six months to three years. Low duration, money market and short duration funds, and fixed deposits where a known date matters more than flexibility.
- Medium-term and income, three to five years. Corporate bond, Banking and PSU, medium duration and target maturity funds.

Earlier versions of our framework carried a fourth tier for long-duration and gilt exposure beyond seven years, taken tactically on a view about the interest-rate cycle.

That tier has been removed. Under the five-year rule, no goal further away than five years is funded from Fixed Income at all, so a long-duration sleeve has no horizon to serve.

Gilt and long-duration funds are still explained in Chapter 5, because the terms are in common use and colleagues need to know what they mean. They are not part of the allocation.

Starting points by client circumstance

These are anchors for a first conversation. They are not a formula, and every allocation is suitability-checked individually.

- Near-retirement or income-dependent: the largest Fixed Income share, sized primarily by the number of years of expenses that must be funded without touching equity.
- Balanced, mid-career, with dated goals inside five years: a moderate share, sized goal by goal rather than as a single percentage.
- Long-horizon with no near-term commitments: the smallest share, often little more than an emergency reserve and a diversification allocation.

Whatever the archetype, money for any goal falling inside three years is ring-fenced and held outside equity. That rule is not flexed for market conditions.

The checks before anything goes in

1. Does the horizon match? The scheme's own duration against the date the money is needed.
2. What is actually inside it? The scheme's specific duration and yield, from its own factsheet, not the category average.
3. What is the credit composition? Not the label on the category, the actual holdings.
4. How liquid is it, and what does exiting cost? Exit loads and redemption terms.
5. What does it look like after tax, against the alternatives? A deposit, a target maturity fund, or a direct holding, compared on what the client keeps.
6. Has the house view been documented and dated? A view that is not written down cannot be reviewed later.

What triggers a review

- A goal date moving inside three years. This forces an immediate shift and does not wait for the next scheduled review.
- A change in the scheme itself: mandate, manager, or a material shift in credit composition.
- A change in the client's circumstances or cash-flow needs.
- A scheduled periodic review, whether or not anything has changed.

Where the interest-rate cycle fits, and where it does not

We form a view on the rate cycle. It informs small tilts within a horizon-appropriate band.

It never overrides the horizon match. The cycle view can change which short-duration fund is held. It cannot extend the horizon of money that has a date attached.

Our own data across nearly two decades of policy changes shows why the discipline matters. Short-tenure instruments track policy rate moves closely and quickly. The long end tracks them only weakly and sometimes moves the opposite way, because it is driven by government borrowing, inflation expectations and foreign flows as much as by policy.

A rate cut is therefore a reliable signal about the short end and a poor one about the long end. "Rates are falling, so buy duration" has failed in this market more than once.

Three gates that sit above the framework

A pressure-test of this methodology added three checks that run before any allocation decision, not as factors inside it.

1. Liquidity gate. Can this holding be exited in stress, when other unitholders are also redeeming? An open-ended fund can be gated by other people's behaviour.
2. Valuation gate. Is the expected move already priced in? A tier tells you the duration you are taking. It does not tell you whether it is cheap or expensive.
3. Fiscal and external gate. What is happening to government borrowing, real rates, the currency and system liquidity? These drive the long end more than the policy rate does.

The reason these are gates and not weights: a weighted score averages a tail risk away. Permanent loss cannot be offset by a good score elsewhere.

Annexe A. Glossary

Every term used in this guide, in plain words.

- Accrual. Interest building up inside a fund day by day, which is why the value drifts upward on quiet days.
- Bond. A loan in tradeable form. The borrower pays interest and repays the amount borrowed on a stated date.
- Coupon. The interest a bond pays, set when it is issued and fixed in rupee terms.
- Credit rating. An agency's opinion of how likely a borrower is to pay. An opinion, revisable at short notice.
- Credit risk. The risk the borrower does not pay, or is downgraded.
- Credit spread. The extra yield a weaker borrower must offer over a government borrower.
- Direct plan. The version of a scheme bought from the fund house, without a distributor commission inside the fee.
- Duration. How much a bond or fund moves in value when interest rates change. Roughly, a duration of three means a one percentage point rise in rates lowers the value by about three per cent.
- Exit load. A charge for redeeming within a stated period after investing.
- Face value. The amount a bond repays at maturity.
- G-sec. A bond issued by the Government of India.
- Growth option. The version of a fund that pays nothing out. Value accumulates in the unit price until you sell.
- IDCW. Income Distribution cum Capital Withdrawal. A payment from a fund that reduces the unit value by the same amount. Called the Dividend option until April 2021.
- Indexation. Adjusting a purchase price for inflation before calculating tax. Withdrawn for debt funds bought on or after 1 April 2023.
- Interest-rate risk. The risk that rates rise and lower the market price of bonds already held.
- Liquidity risk. The risk that an investment cannot be turned into cash quickly at a fair price.
- Mark to market. Revaluing holdings at today's market price rather than what was paid.
- Maturity. The date a bond repays.
- NAV. Net Asset Value. The per-unit value of a mutual fund.
- Reinvestment risk. The risk that money coming back has to be re-lent at a lower rate than before.
- Repo rate. The Reserve Bank's main policy interest rate.
- Sequencing risk. The risk that a market fall lands just before you need the money, turning a temporary decline into a permanent loss.
- SWP. Systematic Withdrawal Plan. A standing instruction to redeem a fixed amount on a fixed schedule.
- Target maturity fund. A fund holding bonds that all mature around a chosen year, so that holding it to that year behaves much like holding the bonds themselves.
- T-bill. A short-dated government borrowing, under a year, issued at a discount rather than paying a coupon.
- Total Expense Ratio. The annual fee of a fund, as a percentage of the amount invested, deducted from the fund's value.

- Yield. The return an investment produces at its current price, as opposed to the coupon printed on it.
- Yield to maturity. The return if every payment is received and the investment is held to maturity. A description of the portfolio, not a promise.

Annexe B. Data Snapshot

Every figure that moves is collected here, and nowhere else in this guide, so that the chapters do not go quietly out of date. Figures below were current in July 2026. Verify against current Reserve Bank, SEBI and Income Tax sources before quoting any of them.

Policy and market rates, week of 3 July 2026

Measure	Level
Repo rate	5.25%
Standing deposit facility	5.00%
Marginal standing facility	5.50%
Cash reserve ratio	3.00%
Statutory liquidity ratio	18.00%
91-day Treasury bill	5.25%
364-day Treasury bill	5.66%
10-year government bond	6.72%
10-year less 91-day spread	+1.47 points
Consumer price inflation, year on year, May 2026	3.94%

The last policy move was a cut of 0.25 points on 5 December 2025. The position since has been a pause rather than a tightening.

Taxation, as at July 2026

This is the fastest-moving fact in the guide. It changed in three consecutive budgets. Verify before every use.

Instrument	Treatment	Approximate top-slab effect
Debt fund bought on or after 1 April 2023	Slab rate, no indexation, any holding period	About 39%

Instrument	Treatment	Approximate top-slab effect
Debt fund bought before 1 April 2023, held beyond 24 months	Flat rate, no indexation	About 15%
Bank or corporate fixed deposit	Interest at slab, taxed as it accrues, tax deducted at source	About 39%
Target maturity fund bought after April 2023	Same as any debt fund, slab rate	About 39%
Treasury bill	Gain at slab rate, since the tenor is under a year	About 39%
RBI Floating Rate Savings Bond	Interest fully taxable at slab	About 39%

The effective percentages assume the top slab under the new regime including surcharge and cess. They are computed rather than quoted from a circular, and they will differ for any investor not at the top slab.

Other reference figures

Item	Figure
Deposit insurance cover	Rs 5 lakh per depositor per bank, principal and interest
RBI Floating Rate Savings Bond coupon, second half of 2026	8.05%
RBI Floating Rate Savings Bond lock-in	7 years
SEBI debt fund categories	16

The 2022 rate cycle, for Chapter 9

Policy rate moved from 4.00% to 6.25% between May and December 2022. Every debt fund category finished the calendar year positive. Liquid funds returned about 4.7% while gilt funds tracking a constant ten-year maturity returned about 0.8%, a gap of roughly 4 percentage points attributable to the rate cycle.

Credit risk funds returned about 13% that year. That was a recovery in credit prices after 2020, not a rate-cycle effect, and it should not be quoted as one.

Annexe C. What We Do Not Know

INTERNAL SECTION. Records the limits of the research behind this guide. Remove before any external distribution.

Stating the limit of a claim in the same breath as the claim is a habit worth keeping. These are the points where the research behind this guide stops.

Two figures that are genuinely unavailable

- There is no published rolling correlation between Indian equity and Indian bond indices for the specific stress windows of 2018, 2020 and 2022. We therefore describe how different segments of Fixed Income behaved, by segment, rather than quoting a single coefficient. The conclusion does not depend on the missing number.
- No named source publishes the maximum intra-year drawdown by debt fund category for 2022. The calendar-year returns are solid; the worst point within the year is not available.

Where confidence is lower than we would like

- The 2022 category return table rests on a single reputable aggregator, and whether it is computed on direct or regular plans is not pinned down. It is the weakest evidence in the set and it underpins the whole 2022 narrative in Chapter 9.
- Tax figures were corroborated through industry and secondary sources because the official portals refused automated access. The interaction between the relevant section and the surcharge cap was reasoned rather than lifted verbatim from a circular.
- Effective tax percentages in Annexe B are our own computation, stated as such.

An open item

- The categorisation of debt funds cited throughout rests on the 2017 SEBI circular. A circular issued in February 2026 post-dates it. Which provisions are operative has not been confirmed, and should be before the category definitions are relied on in client work.

The standing line

Any tax, regulatory or rate figure in this document must be checked against current Reserve Bank, SEBI and Income Tax circulars before it is repeated to a client. Figures are current as at July 2026.