

Should you buy a short-tenor MLDs in the Secondary market

Meta Description: This blog explores the advantages and risks of investing in Market Linked Debentures (MLDs), a type of alternative investment, with a focus on whether buying short-tenor MLDs in the secondary market is a wise decision.

Investors seeking an extra bit of return than usual often resort to pouring money in alternative investments as they provide a much-needed diversification to the portfolio and also help earn a more-than-usual ROI. In such a situation, MLDs (Market Linked Debentures) have become quite popular alternative investment forms due to their features that allow an investor both the benefits as discussed before.

This blog talks about whether an investment in a short-tenor MLD is advisable. Whilst answering this, the blog also takes account of the meaning and types of MLDs along with a working example to make a reader understand how these securities work. In addition, the blog will also take account of the erstwhile and existing tax benefits available on investing in MLDs along with the benefits and risks that an investor might have to face after deciding to put money in MLDs.

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What are MLDs and their categories

As per the definition [devised by SEBI \(Securities Exchange Board of India\)](#) and this is not verbatim:

"Debentures are debt securities offered by a company by which it acknowledges its obligation to repay the amount at a future date. It also carries interest and is one of the popular ways of raising finance used by companies."

On the other hand, MLDs are a category of non-convertible instruments where the returns are not fixed but are dependent on a particular benchmark or market index. These are structured so that

periodic pay-outs are pretty uncommon and an investor could expect returns at the time of maturity (which include interest and appreciation derived from the underlying asset's performance).

The benchmark or index with which the performance of the MLDs is linked can be popular equity indices such as SENSEX or Nifty 50. Other benchmarks can be government securities. The maturity period of MLDs could range from anywhere between a year to five years.

From a broad theoretical categorisation, MLDs are divided into the following types:

Principal-protected MLDs: As the name suggests, the MLDs that guarantee security of the principal invested, irrespective of how the underlying asset might have performed.

It implies that, for example, an investor puts Rs. 1 crore in a protected MLD (with 12% coupon provided Nifty 50 does not fall more than 20%). The MLD has linked its performance with NIFTY 50 for a period of 3 years during which the index provided negative returns (around 25% negative). The MLD will still guarantee repayment of the principal amount (of Rs. 1 crore) without paying any coupon.

However, investors often need to pay upfront for this downside protection in the form of lower potential returns. This means that the rate of return expectations is lowered with the availability of principal protection.

Non-principal-protected MLDs: This type of MLD is typically the opposite of the one discussed before. There is no guarantee of protecting the principal investment as the returns are linked directly with the underlying asset or benchmark. However, the potential returns could be higher, specifically in case when the underlying asset or benchmark performs better than expectations.

How is MLD different from equity index-linked Mutual Fund: A practical example

One of the questions that often comes to mind of a reader is the difference between an MLD and an equity index-linked MF, as from the definitions, the two seem to have a few similar characteristics. However, unlike the index-linked mutual funds, MLDs have a lower chance of a downside risk, especially in the context of a principal protected option.

In addition to this, the tax advantages (erstwhile) available with MLDs made them a better alternative than mutual funds.

Numerical Illustration:

Suppose that an investor invests ₹1,00,000 in an MLD that is linked to the performance of the Nifty 50 index, with an interest rate of 5%. At the end of the investment term, if the Nifty 50 index has increased by 10%, the investor will receive a return of ₹5,000 + ₹10,000 = ₹15,000 on their investment, which is a fixed return. This return would also be subjected to tax benefits earlier (discussed later in the blog) which makes the overall investment more attractive than MF, which is described in the next para.

On the other hand, suppose that the same investor invests ₹1,00,000 in an EILMF that tracks the Nifty 50 index. If the Nifty 50 index increases by 10% during the investment term, the return on the EILMF will also be 10%. However, if the Nifty 50 index decreases by 5%, the return on the EILMF will be negative 5%. This means that the return on an EILMF is variable and is dependent on the performance of the underlying stock index only with no downside protection as it was in case of MLDs.

Which category of investors prefers investment in MLDs?

Due to the high investment requirements in the MLDs, they are often preferred by HNIs (High Net worth Investors) and Ultra HNIs. In addition to the high investment requirements, tax benefits which were available earlier on MLD investments made them an excellent investment alternative for such category of investors.

However, with the reduction of FV (Face Value) of MLDs to Rs. 1 lakh ([w.e.f. 1-January 2023](#)), technically the investment can start with this amount, thereby making way for retail investors to join the MLD bandwagon. This, however, shall be as per terms and conditions of the issuer.

What were the tax benefits on MLDs, and are these still available?

The returns on MLDs are subjected to capital gain tax. Capital gain taxes are categorised into long and short-term. Earlier, MLDs were classified as long-term capital assets in case the security's holding period was more than 12 months. This was subjected to a tax rate of 10%. Hence, the HNIs and Ultra HNI investors had an excellent arbitrage opportunity since returns were higher and taxes were lower.

However, based on the recent amendments in the taxation laws in the country, MLDs have [lost preferential taxation](#) rates. With the new regulations, MLDs will be taxed as short-term capital gains (at the given slab rate applicable to individual investors). Hence, the investors are subjected to regular taxes, such as NCDs, offering no tax benefits.

Most critical benefits of buying short-tenor MLDs in the secondary market

Listed MLDs provide a significant degree of flexibility in the hands of the investor and hence could be an excellent choice for investment in the short term. Some of the reasons why investors wish to invest in the MLDs are as follows:

- There might be an opportunity to buy MLD at a discount, especially when the market conditions allow.
- This opportunity to purchase an MLD from the secondary market at a discount can provide a higher degree of return to the investor.
- There are several listed MLDs with different terms and conditions which could be chosen, thereby giving a chance to diversify the portfolio, especially for HNIs and Ultra HNIs
- Finally, buying MLDs from the secondary market provide a significant level of flexibility in the hands of the investors that include reduction of maturity period and realising gains as soon as they want.

Hence, there are multiple reasons why investing in short-tenor MLDs in the secondary market is advisable to investors. There are, however, a few risks which are discussed in the next paragraph.

Risks of investment in short-tenor MLDs in the secondary market

The risks are pretty similar to other stock-market-linked securities. For instance, an investor might need to face volatility and unpredictable market movements whereby losing money or not receiving the expected rate of return is a possibility. Additionally, MLDs may have complex payout structures that can be difficult for investors to understand. There are additional external factors which affect the MLD value in the secondary market that an investor should consider.

Summing up

To sum up, investment in a short-tenor MLD can have multiple advantages based on the very nature of the investment. The blog explained the meaning of MLDs by underlining some simple working examples. Even though there are a few risks involved in respect to putting money in MLDs through secondary market, the benefits outweigh them quite comprehensively. As with any investment, investors should carefully consider their risk tolerance and objectives before investing in MLDs or any other investment product.

Frequently Asked Questions on MLDs

Do Marked Linked Debentures still have an edge over Mutual Funds?

Yes, MLDs are more attractive as compared to the MFs as they provide principal amount protection along with minimum downside risk compared to MF which are exposed to market movements and volatility.

Can individual investors invest in MLDs or is it restricted for institutional investors only?

Any kind of investor can put money in MLDs provided the minimum limit of investment is satisfied, which is why HNI (High Net worth Investors) often prefer this investment form.

Are MLDs regulated by SEBI?

Yes, MLDs in India are regulated by the Securities Exchange Board of India.

Are MLDs listed on stock exchanges in India?

Yes, generally MLDs are listed on secondary markets and stock exchanges.

Can you name some popular MLDs in India?

Some popular MLDs service providers include Edelweiss Alternative Asset Advisors Ltd., Citicorp Finance (India) Limited, Credit Suisse Finance (India) Private Limited, and Reliance Capital Limited.

Is the change in tax laws applicable on all MLDs or only ones issued on or after 1st April 2023?

Starting with 1st April 2023, MLD returns will be treated as STCG (Short Term Capital Gain). Hence, the changes must apply on all MLDs sold or matured on or after 1st April 2023.

What shall be the highest rate of taxation on MLDs post the removal of tax benefit?

The slab rate on STCG shall be applicable which can go up to 30% on the gains earned by an investor.