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GLOBAL INVESTING ROUTES DRYING UP P8

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5 REASONS TO INVEST IN NPS

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By **Babar Zaidi**

When the National Pension System (NPS) was opened to the general public 15 years ago, it managed to get less than 5,000 voluntary investors. The investment rules were not very clear, the structure was quite complicated and there was also no clarity on the tax treatment of the income.

But over the years, the NPS has undergone many changes and become more investor friendly. The Pension Fund Regulatory and Development Authority (PFRDA) has made the scheme more flexible and introduced new features. It has also made it easier to open an NPS account. If you have the necessary documents, the account can be opened online within minutes. The Finance Ministry has done its bit by introducing tax benefits on contributions, including tax deductions that are exclusive to the NPS and making 60% of the maturity corpus tax free.

As a result, the NPS is slowly gathering pace. In 2023-24, some 8.73 lakh voluntary investors joined the scheme. That's an average 2,391 investors joining per day, almost 100 every hour. But the NPS is still not the preferred investment vehicle for retirement. With only 55 lakh voluntary investors, it has tapped only 10% of the total investing population in the country.

There are many reasons for this, including low awareness about the scheme, aversion to locking up money for the long term and the compulsory annuitisation of 40% of the maturity corpus. However, investors who stay away from NPS may be missing out on a great investment opportunity. "The NPS offers everything that one looks for in a retirement savings product. It is a long-term investment with very low costs and a low risk profile," says Rahul Bhagat, CEO of DSP Pension Fund (*see interview on page 4*). Here are five reasons why you should consider joining the scheme.

1 Very low charges mean higher returns for you

The fund management charges of the NPS are very low compared to what mutual funds and insurance companies charge. "The NPS is the cheapest product available in the Indian market," says Bhagat. The investor pays just ₹30-90 per lakh in a year. That is comparable to what ETFs floated by mutual funds charge, but is a fraction of the nearly 2-2.5% you pay for actively managed equity funds.

Though a fund management charge of 2% a year appears low, it adds up to a substantial sum in the long run due to compounding. Here's a perspective: If you do an SIP of ₹5,000 in a mutual fund that charges 2% per year, over 25 years you will shell out about ₹19 lakh in fund management fees. The same amount invested in

Use NPS tier II to earn more

NPS Tier II debt funds have done better than similar fund categories.

	1-year returns (%)
Best NPS Tier II Gilt fund	7.92
Best long-duration debt fund	7.85
Average NPS Tier II Gilt fund	7.48
Average long-duration debt fund	6.77
Best NPS Tier II Corp bond fund	7.71
Best corp bond mutual fund	7.71
Average NPS Tier II Corp bond fund	7.27
Average corp bond mutual fund	6.5

Data as on 24 Apr 2024. **Source:** Value Research.

Low costs, high returns

Low charges helped NPS equity funds beat large-cap mutual funds.

	Returns (%)		
	3-year	5-year	10-year
Flexi-cap equity funds	19.57	16.47	15.54
NPS equity funds	19.36	15.97	14.03
Large-cap equity funds	19.06	15.58	13.82

the NPS will cost you only ₹1 lakh over 25 years, assuming the maximum 0.09% fund management charge of the NPS. We have assumed compounded annual returns of 9% in this calculation.

The low charges translate into higher returns for the investor. This is why NPS equity funds have consistently beaten the large-cap mutual fund category in the past 10 years and even the flexi-cap category is ahead by a slim margin (*see table*).

Don't want to lock up your money in the NPS till the age of 60? Investors can go for the NPS Tier II option where there are no tax benefits on contributions but also no restrictions on withdrawals. You can invest today and withdraw the money the next day. There is also no exit charge.

At 0.5-1.25%, the fund management charges of debt funds are lower than those of equity funds, but they still can't match the ultra-low costs of NPS funds. This is why NPS debt funds have done better than debt schemes of mutual funds. In the past one year, the NPS Tier II Gilt and Corporate Bond funds have delivered higher returns than the average long-duration debt fund and corporate bond fund (*see tables*).

You can invest in the NPS Tier II only if you have the regular Tier I account. All one has to do is activate the NPS Tier II option and start investing in the scheme. Readers should note that investing in Tier II works well for the gilt and corporate bond funds, but not so much for equity funds because there is ambiguity in the tax rules. Some tax experts point out that the capital gains arising from investments in the NPS Tier II funds may not be eligible for the favourable tax treatment that investments in stocks and equity-oriented mutual funds enjoy. Long-term capital gains of up to ₹1 lakh are tax free in a financial year. Beyond ₹1 lakh, the long-term gains are taxed at 10%. Short-term capital gains are taxed at 15%.

However, since there is no securities transaction tax paid on NPS transactions, the investment will not get these benefits. The capital gains will be added to the income of the individual and taxed at the marginal rate applicable to him. "This will not suit taxpayers in the 20% tax bracket and above," says Chartered Accountant Nishant Khemani. "The higher tax on capital gains from equity investments will take away any advantage accruing from the lower costs," he adds.

2 NPS investments get exclusive tax benefits

Though investments in the NPS Tier II don't get any tax benefit, the Tier I option is loaded with tax incentives. There are three ways to save tax with NPS. Firstly, contributions to the scheme are eligible for deduction in the overall ₹1.5 lakh limit under Section 80C. Then there is an additional deduction of ₹50,000 for contributions under Section 80CCD(1b). This is over and above the Section 80C deduction and exclusive only to the NPS. Taxpayers in the 30% bracket can save up to ₹15,600 by investing ₹50,000 in the scheme. If one factors in the tax savings, the net outflow for the investor will be only ₹34,400 (or ₹2,866 per month).

The third way to save tax through the NPS has a potentially bigger impact on the tax outgo of the individual. Under Section 80CCD(2), up to 10% of the basic salary put in NPS is tax free. For example, if a person has a basic salary of ₹50,000, his company can reduce some other taxable emolument by ₹5,000 and put that amount in the NPS on his behalf every month. The ₹60,000 thus contributed to the NPS will reduce the annual tax of the employee by ₹18,720. However, this NPS contribution should be a part of the emoluments of the individual and can be done only through the company. Incidentally, this deduction under Section 80CCD(2) is available under the new tax regime as well.

At the same time, experts say one should not look at retirement planning through the prism of tax savings. "The PFRDA is encouraging NPS as a complete retirement planning tool. We have to move away from projecting NPS as just a tax-saving instrument," says PFRDA Chairman Deepak Mohanty. "The fresh branding attempts with the tagline NPS#ZaruriHai is an attempt in this direction," he adds.

Put your NPS on auto mode

Investors not sure about the asset mix can go for Lifecycle funds of the NPS

CONSERVATIVE
Equity exposure is 25% at start and reduces by 1% every year after 35 years.

MODERATE
Equity exposure is 50% at start and reduces by 2% every year after 35 years.

AGGRESSIVE
Equity exposure is 75% at start and reduces by 4% every year after 35 years.

3 Choices have increased for investors

With DSP Pension Fund starting operations last year, investors in NPS can now choose from 11 pension fund managers. They are also allowed to change their pension fund manager once a year. Till last year, an NPS investor could invest in schemes of only one pension fund manager. The performance of pension fund managers varies across the four categories. If you look at 10-year returns, the equity funds of Kotak Pension Fund and HDFC Pension Fund are the top performers. But LIC Pension Fund scores in the gilt category while UTI Retirement Solutions and HDFC Pension Fund are best performers in corporate bond fund category. In November 2024, the PFRDA changed the rules and allowed investors to invest across three pension funds. They can now cherry pick the best performing pension funds across different asset classes and invest accordingly.

4 Flexibility has also increased significantly

The NPS has also become more flexible. Investors can alter their asset mix up to four times in a year. The best part is that switching from one asset class to another or changing your pension fund manager will have no tax implications. In mutual funds, switching from one fund to another is treated as a sale and any gain is taxable.

The apart, NPS equity funds used to invest in only index based stocks. But in 2021, the PFRDA allowed investments in the top 200 stocks. This gives pension funds a bigger universe and allows them to take exposure in stocks with long-term potential.

Also, there is greater freedom in deciding your asset mix. The 50% cap on equity investments, which was a sore point for many investors, has been raised to 75%. This will suit younger investors as well as those with a higher appetite for risk. Subscribers who are not very investment savvy can go for any of the three Lifecycle funds that continuously change the asset mix as the person ages (*see graphic*). These funds are the only true asset allocation product that automatically changes the allocation with age. "Lifecycle funds suit investors who don't have the time or the knowledge to decide their asset allocation," says Bhagat.

Investors are also allowed to continue contributing to the NPS up to the age of 70. They can also defer the withdrawal of the 60% tax-free portion up to the age of 75. This means an investor can continue to benefit from the low-cost structure of the NPS well into his retirement even as he keeps withdrawing from the corpus.

5 There is greater liquidity with changes in rules

Investing in the NPS does not always mean the money is locked up till retirement. Like in case of the Provident Fund, withdrawals are allowed for specific reasons, including medical emergencies, marriage or education of children, and purchase or construction of a house. But withdrawals are allowed only if you have been an NPS subscriber for at least three years and only three times during the entire tenure of the NPS account. One can withdraw up to 25% of the contribution in NPS at any time, excluding those made by one's employer.

Can variable annuities be game changers?

Some portion of the annuity will be invested in equity to earn more than fixed income avenues

WHEN THEY RETIRE, NPS investors have to put 40% of the maturity corpus in an annuity that gives them pension for life. For many investors, this is the deal breaker that keeps them away from the NPS. That's because annuity rates are not very high and most people feel they can earn better returns by investing the money in other avenues.

Investors are also psychologically uncomfortable with the idea of giving away control of a big chunk of their retirement savings. Even those who agree to buy annuities, go for the return of purchase price option which gives back the principal to their legal heirs after the investor's death.

The introduction of variable annuities could change that. The insurance regulator has given the go-ahead to variable annuity plans. These variable annuity plans follow complex investment strategies that use derivatives to provide enhanced returns while controlling the risk of investing in equities.

According to news reports, the first variable annuity products could be launched within the next 2-3 months. To start with, variable annuity products are likely to focus on plain vanilla options with equity-linked returns. The benchmark for these returns can vary, ranging from the benchmark indices such as Nifty or Sensex to specific equity funds offered by insurers.

Under these variable annuity plans, 60-80% of the purchase price would be invested in fixed income instruments and offer a guaranteed minimum pension. The remaining 20-40% of the corpus would be invested in equities and equity-linked instruments to earn higher returns. Customers can choose how much they want to allocate to equity investments.

The regulator has asked insurers to explicitly state the variation of annuity payouts in relation to the benchmark in their filing documents. They are also required to provide illustrations of annuity rate variability along with associated risks, which would help customers in making an informed choice.

However, variable annuities that invest in equity instruments is a double-edged sword. If equity markets don't perform well, the expected high return may not happen. Then the pension of the retiree will be even lower than what a fixed annuity pays right now.

"NPS offers everything one needs in a retirement product"

It is a long-term investment, has very low costs and comparitively low risk. Investors should look beyond tax and invest more than the deduction limit, Rahul Bhagat tells **Babar Zaidi**

Rahul Bhagat
CEO, DSP Pension Fund

DSP has returned to the NPS after several years. What made you come back?
The pension market has matured and the regulatory framework is more robust now. Instead of applying for a licence every five years, we now have a perpetual licence. The very low charges have also been revised. The charges are still quite low, but enough to make the business viable in the long term. All this gives us confidence to stay in the business for the long term.

What makes the NPS a better product than other retirement options?
The NPS offers everything that one looks for in a retirement savings product. It is a long-term investment with very low costs and a low risk profile. The investor can start at 18 and remain invested in the scheme till the age of 75. The NPS is also the cheapest product available in the Indian market. The investor pays 0.03-0.09% per year, which is very low compared to what mutual funds and insurance companies charge.

NPS is also low risk because of the tightly regulated environment and the investment approach of the pension fund managers. Pension funds have to declare their portfolios to the PFRDA on a monthly basis.

That apart, the NPS equity funds invest in the top 200 companies, which is a safer universe than the broader market. The gilt funds invest in government bonds where there is no risk of default. Corporate bond funds have a higher risk profile than gilts, but the PFRDA allows funds to invest only in bonds with a minimum rating of AA, though DSP Pension Fund doesn't go below AA+.

NPS equity funds can now invest in stocks beyond the Nifty. Would this enhance the risk or deliver higher returns for investors?
Looking beyond the index stocks Also, NPS is a long-term product and unlike mutual funds, the pension funds do not face the possibility of redemption pressure. Pension fund managers can therefore invest in very long-term bets in which they have conviction.

The top five stocks in the equity portfolios of all pension funds are very large-cap stocks. But your equity fund also has Coramandel International among the top five stocks.
We follow a strategy of a concentrated portfolio. If we have conviction in a stock, we will invest in it and hold it for the long term. We generally prefer companies with zero debt, because such stocks tend to do well in the long term.

NPS offers several advantages to investors, yet very few people (barely 10% of the total investing population in India) have invested in it. Why are people staying away from the NPS?
The commitment for a long term investment is not there. Investors seek liquidity in investments and a window for withdrawal. The NPS is a very good product and will benefit the investor, but people are psychologically averse to putting money in a scheme that they can't touch till retirement. Just like *Mutual Funds Sahi Hai*, we need a campaign saying *NPS Zaruri Hai*.

Also, there is a serious lack of awareness about the NPS. For instance, not many people know about the tax benefits offered by the NPS. One can withdraw 33% of the superannuation fund and the remaining 66% is annuitised. But if you transfer the superannuation corpus to the NPS, you can withdraw 60% tax-free and only 40% will go into annuity.

Similarly, one can build a big corpus using the NPS Tier II. If there is a shortfall in the retirement savings, the NPS Tier II can be transferred to the NPS Tier I account.

> Some part of the retirement portfolio should generate assured income for the retiree. That is exactly what the 40% put in the annuity does.

We note that many investors invest only ₹50,000 a year in NPS to avail tax deduction. That won't build a sufficient corpus. Should the deduction limit be raised to encourage people to invest more?
It is true that ₹50,000 a year will not create a big enough corpus. But even if the limit is raised to ₹2 lakh, that won't help build a sufficient corpus. People must look beyond taxes when saving for their retirement. We are going to live longer than earlier generations and expenses will be higher in the future. Longevity will rise to about 85 years in the future, so a person must save to sustain 20-25 years in retirement.

The compulsory annuity of 40% of the corpus is a sore point for many investors. What are your views on this?
Annuity should not be a sore point, because it offers a fixed and assured income for life. It is like a fixed deposit for the rest of your life. An annuity does away with the reinvestment risk and the risk of longevity. At least some part of the retirement portfolio should generate a fixed and assured income. That is exactly what the 40% portion put in the annuity does for you.

There is another positive point about annuities. Indian parents tend to get sentimental when it comes to children and spend their retirement savings on their goals. As a result they often are left to fend for themselves in their old age. An annuity ensures that the retiree gets a fixed income for life.

Please send your feedback to
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How NPS funds have performed

Don't base your decision on short-term perfromance but look at the long-term returns.

Equity funds

PENSION FUND MANAGER	Returns (%) 6-MONTH	1-YEAR	3-YEAR	5-YEAR	10-YEAR
Aditya Birla Sun Life Pension	17.49	33.57	18.16	15.96	--
AXIS Pension Fund	17.83	33.52	--	--	--
HDFC Pension Fund	18.19	32.86	18.55	16.29	14.43
ICICI Prudential Pension Fund	19.70	37.21	19.88	16.60	14.21
Kotak Pension Fund	17.61	35.03	19.56	16.60	14.19
LIC Pension Fund	17.75	32.86	19.20	15.74	13.29
Max Life Pension Fund	18.57	34.85	--	--	--
SBI Pension Fund	16.94	32.54	18.20	15.04	13.61
Tata Pension Fund	21.97	39.30	--	--	--
UTI Retirement Solutions	20.86	37.05	19.51	15.96	14.34
Average	**18.69**	**34.88**	**19.01**	**16.03**	**14.01**

NPS equity funds are large-cap oriented, though some also hold stocks that are not in the Nifty. The long-term returns are fairly decent and comparable with the returns of large-cap and flexi-cap diversified equity funds.

Gilt funds

PENSION FUND MANAGER	Returns (%) 6-MONTH	1-YEAR	3-YEAR	5-YEAR	10-YEAR
Aditya Birla Sun Life Pension	5.69	7.91	6.03	8.33	--
AXIS Pension Fund	5.68	7.48	--	--	--
HDFC Pension Fund	5.65	7.70	5.61	8.30	9.22
ICICI Prudential Pension Fund	5.40	7.79	5.74	8.10	9.18
Kotak Pension Fund	5.52	7.92	5.87	8.24	9.24
LIC Pension Fund	5.47	7.74	5.73	8.40	9.80
Max Life Pension Fund	5.42	7.86	--	--	--
SBI Pension Fund	5.66	8.04	5.70	8.13	9.30
Tata Pension Fund	5.48	7.74	--	--	--
UTI Retirement Solutions	5.64	8.08	5.72	8.04	8.99
Average	**5.56**	**7.83**	**5.77**	**8.22**	**9.29**

NPS gilt funds tend to have a long-duration orientation, so they will be very sensitive to interest rate movements. Their long-term returns are higher than what long-term bond funds have earned during the same period.

Corporate bond funds

PENSION FUND MANAGER	Returns (%) 6-MONTH	1-YEAR	3-YEAR	5-YEAR	10-YEAR
Aditya Birla Sun Life Pension	4.38	7.59	5.96	8.23	--
AXIS Pension Fund	4.08	7.27	--	--	--
HDFC Pension Fund	4.42	7.77	6.17	8.41	9.17
ICICI Prudential Pension Fund	4.29	7.65	5.92	8.01	9.06
Kotak Pension Fund	4.16	7.47	5.75	7.43	8.59
LIC Pension Fund	4.21	7.16	5.72	8.20	8.85
Max Life Pension Fund	4.11	7.15	--	--	--
SBI Pension Fund	4.28	7.39	5.80	8.06	8.94
Tata Pension Fund	4.43	7.37	--	--	--
UTI Retirement Solutions	4.16	7.38	5.67	7.78	8.62
Average	**4.25**	**7.42**	**5.86**	**8.02**	**8.87**

Corporate bond funds have a shorter maturity profile than gilt funds, but are also sensitive to interest rate movements. The short- and long-term returns are slightly lower that what NPS gilt funds have earned.

Alternative investment funds

PENSION FUND MANAGER	Returns (%) 6-MONTH	1-YEAR	3-YEAR	5-YEAR	7-YEAR
Aditya Birla Sun Life Pension	6.66	8.55	7.14	6.10	--
AXIS Pension Fund	3.36	6.85	--	--	--
HDFC Pension Fund	7.43	9.51	8.73	8.47	8.64
ICICI Prudential Pension Fund	6.70	7.19	6.65	6.43	6.80
Kotak Pension Fund	9.08	10.01	6.06	6.94	7.03
LIC Pension Fund	5.91	7.50	6.81	7.45	7.61
Max Life Pension Fund	3.66	7.10	--	--	--
SBI Pension Fund	7.92	11.08	7.55	9.19	8.91
Tata Pension Fund	5.02	8.61	--	--	--
UTI Retirement Solutions	6.83	6.51	6.58	5.80	6.20
Average	**6.26**	**8.29**	**7.07**	**7.20**	**7.53**

There is a very high degree of variation in the returns of NPS alternative investment funds. Going by the overall average returns generated by the category, the risk of investing in these funds does not seem worthwhile.

Data.as on 22 Apr 2024; returns of over one year are annualised; DSP Pension Fund not included because it started operations five months ago **Source:** Value Research