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FD or mutual fund loan? Experts break down the cheaper way to raise cash

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Article Content:

Loans against FDs come cheaper and are safer, while mutual funds can amplify gains but carry risks. Experts explain when each works best and what safer alternatives exist.

Most of us turn to our investments when there is a need for urgent capital. But breaking fixed deposits (FDs) or SIP is not a good option. You can also take a loan against your FDs and mutual funds (LAMFs).

While both can help, both the loans come with varying cost, risk, and suitability.

Interest rates and costs

Loans against FDs are usually cheaper and come with fewer charges.

"FD loans are typically just 1-2 per cent above the FD rate, making them a low-cost option," said Sameer Mathur, managing director and founder of Roinet Solution.

In contrast, loans against equity mutual funds can attract interest rates of 9.5-11 per cent, with loan amounts capped at around 45-50 per cent of the net asset value (NAV). Debt funds, being less volatile, may allow borrowing of up to 90 per cent of NAV at slightly lower rates, he added.

Processing fees are also lower for FDs.

"Fixed deposits have a fixed value, while mutual funds fluctuate with the market. That's why processing fees and charges are higher for loans against mutual funds," explained Shravan Shetty, managing director of Primus Partners.

Risks in turbulent markets

The biggest differentiator is risk.

“The fundamental risk of pledging mutual funds is that the market can fall, and the lender may ask you to top up the loan. FD principal does not fall as it does not involve capital market risk,” said Ranjit Jha, managing director and chief executive officer of Rurash Financials.

Shetty agreed, noting that in sharp market downturns, investors have faced forced liquidation of their mutual fund holdings at depressed values, leading to significant losses. “During black swan events, when markets fall, pledged mutual fund values drop along with the portfolio, creating severe fund blockages,” he cautioned.

When to choose what

For safety and predictable costs, experts lean towards FDs. “Loan against FD always makes more sense as you get the most competitive rates without fluctuation of the principal,” Jha said.

Mathur added that FD loans are best for short repayment periods or when borrowers cannot take risks.

However, pledging mutual funds can work for those willing to leverage. “Some investors borrow against mutual funds when they expect markets to rise and want to magnify their gains. For instance, if markets go up 30 per cent, a geared investor could make around 45 per cent, minus interest costs,” Jha explained.

Alternatives for urgent cash

For quick liquidity, experts also suggest other avenues. “Liquid and ultra short-term funds are safer alternatives, redeemable within a day and often yielding returns comparable to FDs,” Mathur said. Overdrafts against savings accounts or partial FD withdrawals with small penalties are also practical short-term solutions, he added.

In short, loans against FDs are cheaper and safer, while loans against mutual funds may suit savvy investors confident of market gains. The choice depends on the urgency, risk appetite, and investment goals of the borrower.