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Arbitrage funds show spark but they are not for DIY investors

If you are investing for the very short term, arbitrage funds may not be a good alternative to liquid funds

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Arbitrage funds have given not-so-impressive returns in the past year or so compared to their competitors in the short-term debt space such as liquid funds. However, post the changes in the norms for valuation of debt securities, the returns from liquid funds are expected to come down and experts see an opportunity in arbitrage funds given expectations of a near-term market rally. Is it time for arbitrage funds to make a comeback into your portfolio for your short-term needs?

Arbitrage funds are hybrid funds that invest in equity shares and the futures market but generate returns that are in line with short-term debt funds. Contrary to the image that their name conjures up—a fund that invests in the risky derivatives market and earns high returns—they are low-risk and their returns reflect short-term interest rates in the market.

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POOR RETURNS

Even the tax advantage available to arbitrage funds has not been able to boost their post-tax returns compared to liquid funds

HOW DO THEY WORK?

Arbitrage is the price differential that may exist between two different markets for the same product. In the case of arbitrage funds, it is the difference between the cash and derivative segment of the equity markets for the same security. Arbitrage funds seek to lock in this price difference by taking equal but opposite positions in the cash and futures market.

Let us understand this with an example. A stock trades at ₹100 in the cash segment and the one-month future trades at ₹102. The strategy to earn this ₹2 will be to buy the stock in the cheaper market, the cash market in this case, at ₹100, and sell the more expensive stock future at ₹102. On settlement day, the price in the cash and futures market will converge. Let's say the price on settlement is ₹103. In the cash market, the investor makes a profit of ₹3, since the stock was bought at ₹100. In the derivatives market, the investor makes a loss of ₹1 since the future was sold at ₹102. The total profit from this transaction then is ₹2 {3+(-1)}. This ₹2 is locked in irrespective of the settlement price. What if the price on settlement is ₹99? The cash position makes a loss of ₹1 since the stock was bought at ₹100. The future position makes a profit of ₹3 since the future was sold at ₹102 and is now being settled at ₹99. The net profit on the trade is again ₹2 (-1+3).

Arbitrage funds create positions to exploit the arbitrage opportunities available in the market. The difference between the two prices is the return for the fund and it is realized when the position created in the cash and derivative market is closed on the expiry date of the future position.

Typically, the one-month future is used to set up this strategy since these are the most liquid contracts. When markets are buoyant or volatile, the opportunities to make profits from the positions taken may present themselves in a shorter time than the period to expiry of the futures position. This allows the funds to get reinvested or churned more often and, thus, arbitrage funds give better returns in such markets. In steady markets, the positions are held to expiry, i.e. around 30 days, and the returns, typically, reflect short-term interest rates.

> **For investment horizons of over three months, this category can be considered in volatile and buoyant markets**

Despite investing in the equity and derivatives markets, arbitrage funds do not carry the risks associated with equity investing. This is because the risk of volatility in the shares bought in the cash market is offset by the equal and opposite derivative positions.

However, in the period till expiry, the positions are marked to market and this may cause volatility in the net asset value. This is corrected once the positions are closed and the locked-in profit is earned. If the investor were to withdraw funds during this time, there may be a loss. Arbitrage funds usually impose an exit load for withdrawals before one month to discourage such activity.

HOW TO USE THEM?

Investors use these funds to park short-term money that would have otherwise been held in liquid funds or ultra short-term funds. The lure is the possibility of higher returns without additional risk.

"We suggest arbitrage funds for investors looking to park their funds for about a year when they are planning for a vacation or an emergency etc.," said Dilshad Billimoria, director, Dilzer Consultants Private Ltd, a Sebi-registered investment advisory firm. "It is important to set the right expectations on return and risk in these funds so there is a proper education we do for clients to help them understand the idea of arbitrage funds before they invest," she added.

Shyam Sekhar, founder, iThought Advisory, a Sebi-registered investment advisory firm, however, believes that the idea did not take off as expected. "Tax efficiency was the primary reason why these funds were being sought out. But with spreads narrowing, that too does not exist anymore," he said.

THE TAX ADVANTAGE

Arbitrage funds score over liquid funds on the taxability of returns. Since they are taxed as equity funds, arbitrage funds tax short-term capital gains at 15% as compared to 30% for debt funds depending upon the tax bracket of the investor. Arbitrage funds and liquid funds pay dividends at frequent intervals to reduce the impact of capital gains taxes on withdrawals. The dividend distribution tax applicable on dividends paid is also lower at 10% for arbitrage funds as compared to 25% for liquid funds.

MINT'S TAKE

The change in the valuation norms of debt securities held by liquid funds are expected to bring down the returns from arbitrage funds as well. The returns from the arbitrage funds depend upon the "basis" or spread available between the prices in the cash and futures market for the stock.

"The arbitrage spread has improved, buoyed by positive sentiment on near-term market rally, build-up to the general elections, Q4FY19 earnings season etc. The current spread is one of the highest in the last few months. Along with the current opportunity, this category provides equity taxation advantage. Also, the relatively lower yields in alternative options (post March) increases the category's attractiveness. However, investors should ideally consider arbitrage funds with three-six months or a higher time horizon," said Anand Gupta, fund manager, Reliance Mutual Fund.

This is not much of a do-it-yourself product and it is best if you take the help of an adviser who can decode the technical details of how the spreads are expected to behave.

If you are investing for the very short term, arbitrage funds may not be a good alternative since returns could be negative or low. For investment horizons of over three months, this category can be considered in volatile and buoyant markets to earn good post-tax returns.

What are hybrid mutual funds and how are they taxed?
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