Wed, 17 May-17; DNA MONEY - DNA - Mumbai; Size : 432 sq.cm.;
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PERSONAL FINANCE

Choose segment, check debt portfolio in hybrid funds

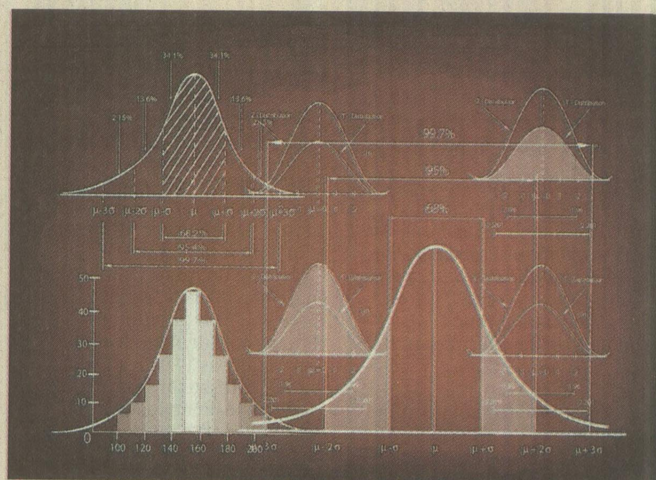
Sundeep Sikka

For first-time investors, dipping their toes into the mutual fund mart, even too many good options can be confusing. If you choose fixed income funds, the returns are steady but low. In case you prefer equity MFs, growth potential is attractive but risk is slightly higher. That's where hybrid funds come in.

Hybrid funds are funds that invest in equity and fixed income based securities – thereby providing investors with an option of investing in single mutual fund that combines both growth and income objectives.

Combining different asset classes, a hybrid mutual fund product ensures investors are able to leverage the high returns from equities over time while also profiting from the steadier gains from fixed income. Hybrid funds are best suited for investors who want to profit from a portfolio containing top stocks and bonds, aim for growth but understand safety. It is ideal for new investors. There are some important factors to consider while buying hybrid funds.

Choosing segment: Hybrid funds let you reap the benefit of diversification, and also the very best of both worlds without putting your assets at risk. Since hybrid funds typically take a larger exposure of equity to give you tax benefits, an investor cannot decide the equity allocation. Investors can, however, decide what kind of equities their money will invest in. This choice is important because it will ultimately decide the quantum of equity returns.



THINKSTOCK

For instance, there are funds that provide the flexibility to participate in investment opportunities across sectors and market capitalization ranges. The fund managers do this mixing the equity allocation between large-cap stocks and mid-cap stocks. Such a multi-cap strategy may be suited for investors wanting higher returns from the equity allocation.

Then, there are hybrid funds that stick to a predominantly large-cap focus. These schemes, with a blue-chip stock bias, would generate more stable and steady returns, especially suited for new investors with a conservative mindset.

Date with debt: An eye of debt allocation and portfolio is also important for those considering hybrid funds. While the upside of fixed income is the certainty of return, it is important to note that this strength is visible only when such instruments are of high-quality. Top-grade interest-bearing securities like corporate bonds, debentures, government securities, commercial paper and other money market instruments, with the right maturity profile and in sync with the interest rate outlook are a must-have.

The relationship between bonds and interest rates affect fund returns. So, it is important to select a hybrid fund whose debt portion is managed by investment experts with experience in handling funds both in the up cycle as well as the down cycle of interest rates. Their track-record should be closely examined. Long-term performance as well as alpha (excess return) over benchmark of debt managers is as much important as of the equity managers.

Selecting lower taxes: Hybrid funds invest their portfolio in a motley assortment of debt and equities. They can be equity-oriented or debt-oriented, contingent on their exposure to equities. If a hybrid fund invests minimum 65% in equities, it is an equity-oriented. Less than 65% equities allocation will mean it is debt-oriented.

There are quite a few tax advantages if you select the right hybrid fund. Equity oriented hybrid funds, if held for more than one year are exempt from long-term capital gains tax. This makes the taxation of these funds identical to 100% equity funds, even though they may have 65% of equity. This is a major advantage because the safety and returns from fixed income portion virtually are tax-free. Dividends are also tax-free.

For debt oriented hybrid funds, the fund assets have to be held for more than three years to qualify as long-term and gains are taxed at 20% with indexation benefits. Short-term capital gains tax on debt-oriented hybrid funds is as per investor's income tax bracket. Dividends attract dividend distribution tax as well.

The writer is executive director and CEO, Reliance Mutual Fund

MULTIPLE BENEFITS

- Hybrid funds give you benefit of diversification
- **Taxation of these funds is identical to 100% equity funds**