Arbitrage funds: Lower risk than equities, similar tax treatment

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Mutual fund investors are showing keen interest in arbitrage funds as these schemes have received net inflows of ₹23,796.5 crore between April and July 2023. While they are gaining in popularity — their assets under management (AUM) stood at ₹90,745.6 crore as of July 31, 2023, according to data from the Association of Mutual Funds in India (Amfi) — experts point out that investors need to moderate their return expectations from these funds.

How do they work?

Managers of arbitrage funds track the cash and futures segment closely. The arbitrage strategy involves benefiting from the price differential between the cash and the futures market. Normally, arbitrage schemes' endeavour is to buy securities in the stock market and sell them in the futures contract market at a better price.

"The difference in the current price of the securities in the cash market and the futures market is called spread. An arbitrage scheme generates returns from this spread: Higher the spread, better the returns, and vice versa," says Chintan Haria, head of investment strategy, ICICI Prudential Mutual Fund.

Attracting attention

From April 1, 2023, capital gains on debt funds are being taxed at the investor's slab rate, irrespective of the holding period. Arbitrage funds, on the other hand, are considered as equity funds and are taxed at 10 per cent if the capital gains exceed ₹1 lakh in a year on units held for more than one year. Short-term capital gains are taxed at 15 per cent. "The change in taxation norms of debt funds is the key reason for investors' tilt towards arbitrage funds. Debt funds were deprived of indexation benefit in the last Budget. This brought them on a par with other fixed-income options," says S. Sridharan, founder and chief executive officer (CEO), Wallet Wealth.

Improved returns

Currently, short-term yields are attractive, which is positive for arbitrage schemes. "Rise in money market yields and improved equity market sentiments in the first quarter of 2023-24 widened arbitrage rollover spreads, lifting arbitrage fund returns. Following three subdued years (2020 to 2022), when returns ranged between 4.3 and 4.7 per cent per annum (for direct plans), the year-to-date category average return has crossed 4.9 per cent in 2023," says Yogesh Kalwani, head, investments, InCred Wealth.

In the last year — ended August 24, 2023 — arbitrage funds have given 7.1 per cent return.

Don't go by past returns

Though these funds don't carry equity risk, and generally generate returns akin to liquid funds, returns can fluctuate from between years. "In the future, the arbitrage spread will depend on inflows (higher demand will suppress the spread and vice versa), short-term rate movements, and market direction (a bullish market would result in a higher spread and vice versa)," says Haria.

Returns could be muted during less volatile times. "There may not be many opportunities to generate gains in stable market conditions," says Haria.

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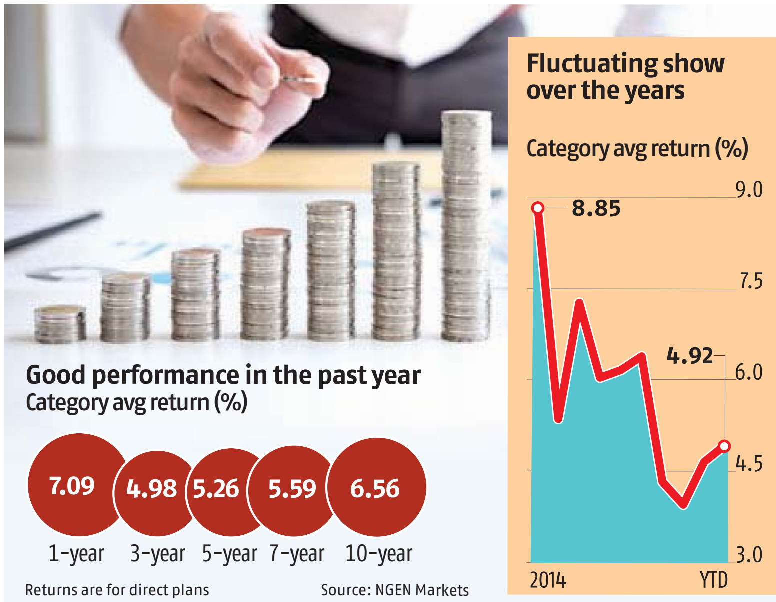

Who should invest?

These funds are not a perfect substitute for liquid and other debt funds. "Arbitrage funds suit investors in the higher tax brackets with an investment horizon of six months to a year. Their tax efficiency, compared to debt funds and lower risk compared to pure equity funds, make them appealing for shorter investment periods," says Tarun Birani, founder and CEO, TBNG Capital Advisors.

How much to allocate?

Allocation to arbitrage funds should align with the investor's risk profile and liquidity requirements. "One can allocate up to 10 per cent or slightly higher to these funds based on one's market view and other considerations such as redemption, profit-booking focus, etc.," says Birani.

Sridharan suggests investing with a time horizon of one to three years.

Choose a scheme with a low expense ratio, as other things remaining constant, a low expense ratio translates into better returns.

"While arbitrage funds involve low risk, their returns are not linear. Look at the fund's AUM, fund manager's track record, and expense ratio before investing," says Kalwani.