What are balanced advantage funds?

Emotions and instincts often guide investment decisions, but they can be harmful for your financial interests. For example, age old investing wisdom is buying low and selling high. However, instead of " buying low and selling high" investors usually buy when market is high, thinking it will go higher. Similarly, investors sell when market is low, thinking it will fall even lower. If you buy at high prices, you will see a large reduction in your portfolio value when market corrects. If you sell when market falls, then you may incur a permanent loss. Fear and greed are the dominant instincts in investing. Fear can lead to sub-optimal returns on your investment, while greed leads to excessive risk taking which is equally harmful for your financial interests.

How can asset allocation help you?

Asset allocation diversifies your investments across different asset classes e.g. equity, fixed income etc, which have different risk profiles. Asset allocation may reduce portfolio volatility and help you remain disciplined in your investments. You should understand that risk and return are related. Asset allocation will balance risk and return, to help you achieve your financial goals. It may provide stability and improve performance consistency of your portfolio. Asset allocation may help you get more tax efficient return and perhaps improve the liquidity of your portfolio.

Dynamic asset allocation, which is changing your asset allocation as per market conditions, can further reduce downside risks and generate risk adjusted returns. If you reduce your equity asset allocation in high markets and increase it in down markets, you not only reduce your portfolio drawdown in down market, you may also get superior risk adjusted returns because you are " buying low and selling high". While different categories of mutual funds can help you get exposure to different asset classes or sub-classes, balanced advantage fund is perhaps the only mutual fund category, which dynamically manages asset allocation according to market conditions.

How do balanced advantage funds work?

Balanced advantage fund is a hybrid fund, which changes its asset allocation i.e. equity and fixed income allocations, dynamically according to market conditions. Balanced advantage funds usually reduce equity and increase fixed income allocations when equity valuations are high. They will increase equity and reduce fixed income allocations when equity valuations are low. These funds use quantitative dynamic asset allocation models to change their asset allocation. By using a model based approach, balanced advantage funds eliminate behavioural biases in investing.

Why should you invest in balanced advantage funds?

- These funds may be less volatile than aggressive hybrid funds because they tend to have lower equity allocations at market peaks. Consequently in corrections they may have lesser drawdowns.
- Balanced Advantage Funds reduce equity allocation when valuations are high and increase it when valuations are low, generating potential risk adjusted returns over sufficiently long investment tenures.
- Balanced Advantage Funds can enjoy equity taxation if their average gross (hedged and un-hedged) equity exposure is 65% or more. However, investors should consult with their financial advisors about the tax treatment of their mutual fund schemes and make informed investment decisions.

How balanced advantage funds manage asset allocation?

- Net or Active Equity: This is the un-hedged equity exposure of the fund. Net equity allocation is determined by a quantitative dynamic asset allocation model based on market conditions.
- Fixed Income: Fixed income allocation is determined by the asset allocation model but is usually capped at 35% to ensure equity taxation.

- Hedging: A part of the equity exposure of the fund is hedged using derivatives (futures and options). For example if a Balanced Advantage Fund has Stock "A" in its portfolio, then it will short (sell) futures of the stock "A" in the derivatives market for hedging. If the share price of stock "A" falls, the net asset value (NAV) of the scheme will go down, but the scheme may make profit on the futures position – the net impact on NAV will be zero. On the other hand, if the price of stock "A" rises, the NAV will go up, but the scheme will make a loss on the futures position – the net impact on NAV will again be zero. Hedged equity component will not have market risks. Hedging reduces the net equity exposure (overall portfolio risk) and at the same time, helps to keep the gross equity exposure above 65%, which enables equity taxation.

How balanced advantage funds work to generate returns?

- The net equity exposure (un-hedged equity) may generate capital appreciation for you over long investment horizons. Historical data shows that equity as an asset class can generate superior inflation adjusted returns over long investment horizons; Nifty 50 TRI gave 14.52% CAGR returns over the last 10 years ending 31st May 2022 (source: National Stock Exchange).
- The fixed income part of the portfolio generates income and provides stability to your portfolio. Different balanced advantage funds may have different fixed income strategies – most schemes use accrual based investment strategies to reduce interest rate risk, but some schemes may take duration calls depending on the interest rate scenario.
- Some balanced advantage funds may generate arbitrage profits in its hedged positions. Schemes may make arbitrage profits (risk free profits) by exploiting price differences in the differences in cash and derivatives (F&O) market. For example if Stock "A" is trading at Rs 100 in the cash market and futures of Stock "A" is trading at Rs 102 in the F&O market, then the fund manager can lock-in Rs 2 of arbitrage profits by simultaneously buying Stock "A" in the cash market and selling futures of Stock "A" in the F&O market. This profit is locked-in irrespective of whether the share price goes up or down.
- In September 2021, SEBI introduced covered calls facility for mutual funds. This provision will allow mutual funds to earn extra income by writing (selling) call options for the stocks held by the scheme in the mutual fund's portfolio.

How to select a balanced advantage fund for your mutual fund portfolio?

There are currently more than 20 balanced advantage mutual fund products in the market. So how will you go about selecting a fund for your needs? The most important consideration should be asset allocation strategies used different funds.

- Most balanced advantage funds use counter-cyclical dynamic asset allocation models. Counter-cyclical dynamic asset allocation models decrease equity allocation and increase fixed income and / or hedging allocation if equity valuations are high. If equity valuations are low, then the model increases equity allocation and decreases fixed income and / or hedging allocation. In counter-cyclical dynamic asset allocation models you are essentially "buying low and selling high". Different balanced advantage funds use different valuation metrics for dynamic asset allocation, the most common being P/E and P/B ratios. Some fund managers use multi-factor models which combine 2 or more factors e.g. P/E, P/B and Dividend Yield etc.
- Some balanced advantage funds may use pro-cyclical dynamic asset allocation models. Pro-cyclical models aim to capture the upside during the bull market and protect downside in bear markets. Funds employing pro-cyclical models increase their equity allocation in rising markets and reduce it in falling markets.
- Some balanced advantage funds may use a combination of both counter-cyclical and pro-cyclical approaches. The core asset allocation of these schemes follow the counter-cyclical method, while the tactically using market trend / momentum based strategies (pro-cyclical) to maximize upside potential and limit downside risk.
- Intuitively, counter-cyclical dynamic asset allocation models should have smaller drawdowns compared to pro-cyclical models because their equity allocations will be low in high markets as opposed to pro-cyclical models. Pro-cyclical models, on the other hand, maybe able to ride momentum in bull markets.
- You should understand the asset allocation strategy used by the scheme (refer to the SID) and make informed investment decisions based on your risk appetite. You should always consult with a financial advisor, if you need help in understand the risk / return characteristics of a mutual fund scheme.
- Investors often make the mistake of selecting funds based on short term performance. You should not invest in a balanced advantage fund, simply based on returns. The fund should also be able protect your downside risks in volatile markets.

What is an effective balanced advantage fund?

An effective balanced advantage fund is one which is able to minimize downside risks and also generate superior risk adjusted returns in the long term. An effective balanced advantage funds should have minimal equity allocation at market peaks and maximum equity allocation at market bottoms. It is never possible to predict market peaks or bottoms with 100% accuracy, but dynamic asset allocation models are back-tested over multiple investment cycles (bull and bear markets) to check whether the model has produced desired results in different market conditions. You should see the performance of a balanced advantage scheme in different market conditions and see which scheme has performed consistently in different conditions.

Frequently asked questions

1. What is the difference between balanced advantage fund and hybrid equity fund?

Answer: Hybrid equity funds or aggressive hybrid funds have 65 – 80% un-hedged exposure to equity and 20 – 35% allocation to fixed income instruments (debt and money market). There are no asset allocation limits for balanced advantage funds e.g. the un-hedged equity exposure of a balanced advantage fund may be much lower than 65%. The risk profile of balanced advantage funds may be lower than that of hybrid equity funds or aggressive hybrid funds?

2. What is the difference between balanced fund and balanced advantage fund?

Answer: As per SEBI, balanced funds must have 50% to equity and 50% allocation to fixed income instruments (debt and money market). There are no asset allocation limits for balanced advantage funds e.g. the un-hedged equity exposure of a balanced advantage fund can be lower than 50%. Furthermore, since balanced funds have 50% allocation to fixed income, they will be treated like debt funds from a taxation viewpoint. Balanced advantage funds usually enjoy equity taxation because they use derivatives to hedge. Equity taxation may be a major advantage for balanced advantage funds.

3. What is the difference between balanced advantage fund and dynamic asset allocation fund?

Answer: Balanced advantage fund and dynamic asset allocation fund are the same. There is no difference between the two. All balanced advantage funds use dynamic asset allocation strategy.