Equity Savings Funds:
Striking a balance between equity, debt and arbitrage

What are Equity Savings Funds?

Equity Savings Funds are Hybrid Mutual Fund schemes which invest in equity, debt and hedging strategies (using derivatives). As per the SEBI Circular overall equity allocation (including hedged and un-hedged exposures) should be minimum 65% of total assets and minimum of 10% of total assets in debt and / or money market instruments. These schemes are also required to mention their minimum hedged and un-hedged exposures in their Scheme Information Document. Equity Savings Funds enjoy equity taxation.

Asset allocation strategy of Equity Savings Funds

- **Debt:** Debt exposure of Equity Savings Funds can range from 10 to 35% of total assets. The debt allocations of these schemes generate income, reduce overall volatility and provide stability to the scheme.
- **Hedged equity:** Hedging is an investment strategy to reduce portfolio risk, by taking an opposite positions on the same underlying assets in different market segments. The most popular hedging strategies involve use of derivatives (e.g. futures, options). For example, you can buy a stock in the cash market and sell it in the futures market. If the stock price falls, then you will make a loss in the cash market but a profit in the futures market, thereby offsetting the loss. Different Equity Savings Funds may have different hedged exposures (read the scheme information document). The main purpose of hedging is to reduce portfolio risk, while enjoy equity taxation benefits because hedged exposure is also considered equity from taxation standpoint.
- **Active (un-hedged) equity:** The entire equity exposure of an Equity Savings Fund is not hedged; a portion of the equity exposure is un-hedged or active with the objective of getting capital appreciation for the investor.

How Equity Savings Funds generate returns?

- **Arbitrage:** The hedged portion of the equity allocation is used to generate arbitrage profits. Arbitrage by definition is defined as risk free profit, by exploiting pricing mismatches in the market. Let us understand how arbitrage works. Let us assume that price of a stock in cash market at the beginning of a month is ₹100 and its price in the futures market is ₹102. The fund manager can lock-in ₹2 of risk-free profits irrespective of how the share price moves because on expiry of the futures contract (the last Thursday of a month), the cash price (also known as spot price and the futures price will converge. The table below shows various scenarios of share price changes and the final profit of the fund manager.

Share Price on expiry	Profit / (loss) in cash market	Profit / (loss) in cash market	Final Profit
₹90	₹(10) loss [90 – 100]	₹12 profit [102 – 90]	₹2 [12 – 10]
₹95	₹(5) loss [95-100]	₹7 profit [102-95]	₹2 [7 – 5]
₹100	Nil [100 – 100]	₹2 profit [102 -100]	₹2 [2 – 0]
₹105	₹5 profit [105 – 100]	₹(3) loss [102 – 105]	₹2 [5 – 3]
₹110	₹10 profit [110 -100]	₹(8) loss [102 – 100]	₹2 [10 – 8]

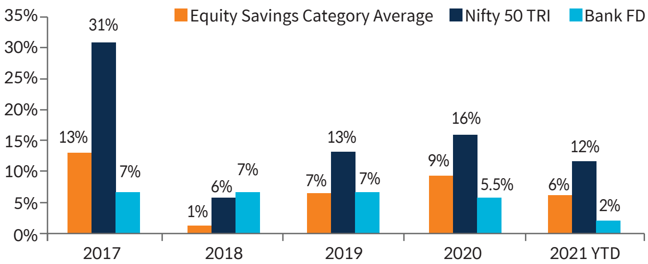
For illustration purpose only.

You can see that the fund manager always makes a profit, whether the share price moves up or down. There is no risk; hence these profits are risk-free profits or arbitrage profits. Capital safety, returns and liquidity are important considerations in arbitrage strategy. In volatile market conditions arbitrage can generate comparable or even higher returns than liquid funds.

- **Debt and Money Market:** In the fixed income / money market portfolio within the overall scheme portfolio of equity savings, the fund managers usually employ accrual strategy to generate income and minimize interest rate risk. In accrual strategy, fund managers hold the debt and money market securities in their portfolio till maturity and accrue the interest (coupons) paid by the debt or money market instruments. However, some fund managers may take duration calls depending on their interest rate outlook.
- **Active Equity:** Equity Savings Funds take active (un-hedged) exposure within specified allocation ranges. Fund managers may increase or decrease active equity exposure depending on market conditions.

Performance of Equity Savings Funds

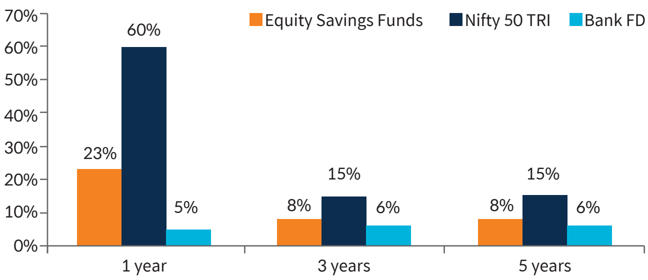
The chart below shows the annual returns of Equity Savings Funds category over the last 5 years versus other asset classes. You can see that, while Equity Savings Funds gave moderate returns relative to Nifty, they have the potential to give higher returns than Fixed Deposit (albeit with higher volatility) over sufficiently long investment tenures.



Source: All schemes in equity savings fund category have been considered in calculating category average returns. 2017 (15 schemes), 2018 (16 schemes). 2019 (21 schemes), 2020 - 21 (23 schemes). Category average return is the arithmetic mean of annual and 2021 May YTD returns of all schemes in the category. FD returns are based on average 1 year term deposit interest rates in State Bank of India for the respective years.

Disclaimer: Past performance may or may not be sustained in the future

The chart below shows the annualized returns of Equity Savings Funds category over different investment periods versus other asset classes.



Source: Advisorkhoj Research (Period: 1.1.2017 to 31.05.2021).

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Taxation Advantage

Equity Savings Funds are taxed as equity funds. Short term capital gains (holding period of less than 12 months) are taxed at 15% (plus applicable surcharge and cess). Long term capital gains (holding period of more than 12 months) of up to ₹1 lakh are tax exempt and taxed at 10% (plus applicable surcharge and cess) thereafter. Dividends paid by Equity Savings Funds are added to investor's taxable income and taxed as per the income tax rate of the investor. The table below illustrates the tax advantage of Equity Savings Funds versus traditional fixed income investment e.g. Bank FD.

Particulars	Equity Savings Fund	Bank FD
Investment	20,00,000	20,00,000
Annualized return	7%	7%
Tenure (years)	2	2
Investment value at end of tenure	22,89,800	22,89,800
Capital Gains / Interest	2,89,800	2,89,800
Exempt Long term capital gains / interest	1,00,000	-
Taxable long term capital gains / interest	1,89,800	2,89,800
Tax Rate	10%	30%
Capital Gains / Income Tax	18,980	86,940
Post Tax Gains	2,70,820	2,02,860
Post Tax Returns Annualized	6.6%	4.9%

Note: Above example is purely illustrative. Please consult with your financial or tax advisor to know the tax consequences of your investment.

Who should invest in Equity Savings Funds?

- Investors who want to get higher returns than traditional fixed income investments without taking high risks.
- Investors with moderate to moderately high risk appetites.
- Investors with at least 3 – 5 years investment horizon.
- Investors should read the scheme information document carefully to understand the asset allocation and risk profile of their schemes.
- Investors should consult with their financial advisors before investing.

An investor education initiative by Mirae Asset Mutual Fund.

All Mutual Fund investors have to go through a one-time KYC (Know Your Customer) process. Investors should deal only with Registered Mutual Funds (RMF). For further information on KYC, RMFs and procedure to lodge a complaint in case of any grievance, you may refer the Knowledge Center section available on the website of Mirae Asset Mutual Fund.

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Mutual Fund investments are subject to market risks, read all scheme related documents carefully.