MIRAE ASSET
Mutual Fund
An Investor Education Initiative

Arbitrage Funds

Tax efficient options for parking short term funds

What is

Arbitrage?

Arbitrage is simultaneous buying and selling the same underlying security or its derivatives in different market segments to make **risk free profits**. If the price of the same object is different in different markets, you can make risk free profits by buying the object in the market where price is lower and simultaneously selling it in the market where price is higher. It is important that both the buy and sell transactions are executed simultaneously so that you can lock-in the profits and not be exposed to price risks. Since arbitrageurs aim to make risk free profits the buy and sell positions are totally (100%) hedged.

Examples of different arbitrage opportunities

1. Exchange arbitrage: Price of the same security is different in two stock exchanges e.g. share of a company is trading at Rs 100 in NSE and Rs 101 in BSE. You can lock-in Rs 1 profit / share by simultaneously buying it in NSE and selling it in BSE.

2. Index and basket of stocks arbitrage: This is essentially same as cash and carry arbitrage – the only difference is that instead of a single stock here the arbitrage is for the index. For example, Nifty is trading at Rs 9,300 in the F&O market whereas equivalent price of a basket of stocks constituting Nifty (in the same proportion as the index) is Rs 9275 in the cash market. You can lock-in Rs 25 profit per Nifty future contract by simultaneously selling Nifty and buying the basket of stocks in the cash market.

How does

cash and carry

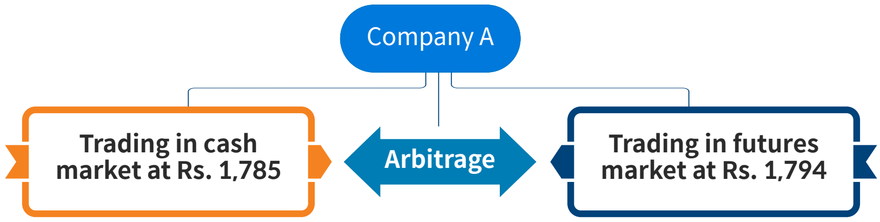
arbitrage work?

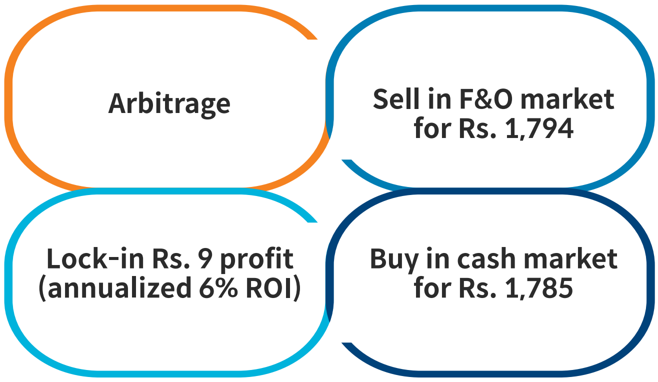
3. Cash and carry arbitrage: Price of the share of a company in the cash market is Rs 1785 and price of the current series future of the same company in the Futures and Options (F&O) market is Rs 1794. You can lock-in Rs 9 profit / share by simultaneously buying the share in cash market and selling it in the future market. Cash and carry arbitrage is the most common arbitrage strategy used by arbitrage mutual funds.

How will you make

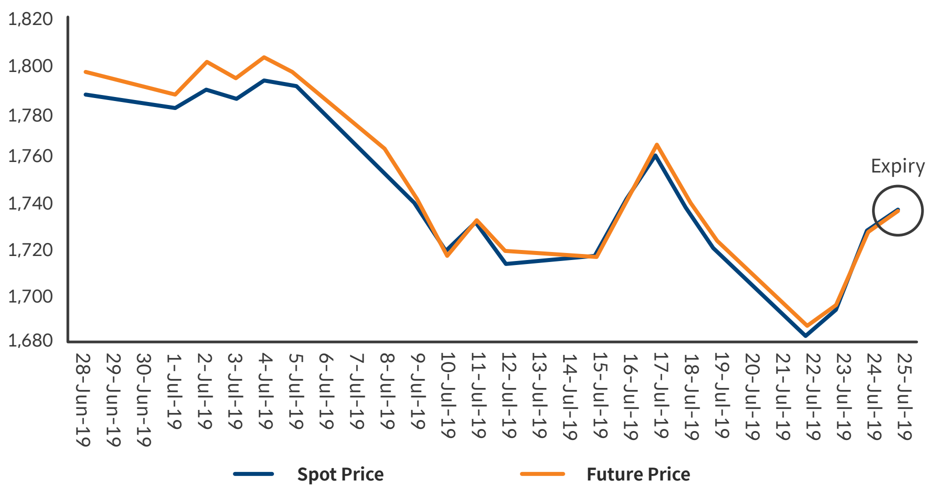
Arbitrage Profit?

Consider the following scenario:





By buying in the cash market and selling in the F&O market you will lock-in the profits irrespective of the price movement of the security because on expiry of the future contract (last Thursday of the month) the cash price and future price will converge.



Disclaimer: The above chart is purely illustrative. There is no assurance of minimum returns in any arbitrage fund

Scenario Analysis of Cash and Carry Arbitrage

	On F&O Expiry Price of Stock		
	Stock Prices goes up to 1900	Stock Prices goes down to 1700	Stock Prices remains 1785
Buy the Stock @ 1785	115	-85	0
Sell the Stock Future @ 1794	-106	94	9
	9	**9**	**9**

4. Arbitrage opportunities created by corporate actions/events

A. Rights issue: This is announced for a company's existing investors when it needs more capital. The company gives an option or 'rights' to an existing investor to buy new shares at a discounted price during a certain period. This offers an arbitrage opportunity as the investor can buy shares at a discount and sell the same when it matches the market price.

B. Mergers and acquisitions (M&A): Merger arbitrage involves trading in the stocks of two merging firms based on their share swap ratio.

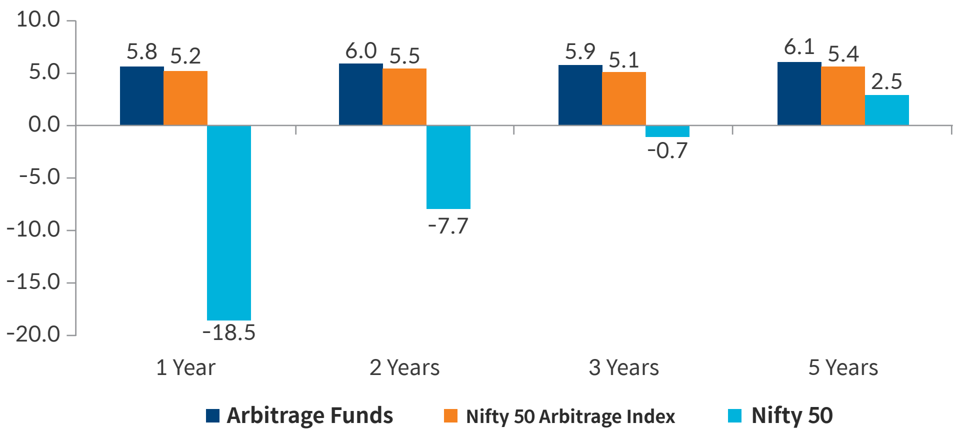
C. Buy-Back Arbitrage: When the company announces the buy-back of its own shares, there could be opportunities due to price differential in buyback price and trade price.

Advantages of Arbitrage for investors

The advantages that these funds provide for investors are:

1. Historic stable performance: Arbitrage funds have given stable positive returns of ~6% in past one year, despite the recent bloodbath in the broader market, which saw the Nifty 50 plunge 18.5% during the period. Further, the category has beaten its benchmark and the market benchmark across point-to-point periods analysed.

Chart 2: Point to point returns performance of arbitrage funds as on May 12, 2020



Source: CRISIL Research
Returns for less than one year is absolute and more than one year one year are annualized
Arbitrage fund category represented by CRISIL ranked funds as of March 2020

Past performance may or may not sustain in future.

The data/performance provided above pertains to the category of scheme and does not in any manner constitute performance of any individual scheme of Mirae Asset Mutual Fund.

2. Opportunity across market scenarios: Arbitrage opportunities are available across market scenarios. In a bullish market or upswing, futures are usually priced higher than cash, thereby creating an opportunity to sell futures of the stock in the derivatives market and buy the stock in the cash market. And in a volatile market as well, as is the current phase, arbitrage opportunities arise as mispricing is high. In fact, while arbitrage funds aim to provide stable returns during bull and bear phases and in volatile phases, like the one we are seeing currently. This can be showcased, in terms of the arbitrage funds' performance across market phases:

Phases	Arbitrage funds	Nifty 50
Sub-prime crisis (January 2008-March 2009)	8.00	-43.42
Sharp bounce back post sub-prime crisis (April 2009-December 2010)	5.17	48.77
European crisis (January 2011-June 2013)	8.66	-1.94
Post-European crisis (July 2013-February 2015)	8.68	28.07
Chinese slowdown (March 2015-February 2016)	6.85	-21.51
Global liquidity and domestic reforms (March 2016-December 2017)	6.12	22.88
Mixed domestic and global scenario (January 2018 till December 20, 2019)	6.07	8.59
Covid-19 crisis (January 2020-May 2020)	2.01	-24.51

Notes: 1) Returns for less than one year are absolute and over one year are annualised
2) Arbitrage fund category represented by CRISIL-ranked funds as of March 2020

Source: CRISIL Research

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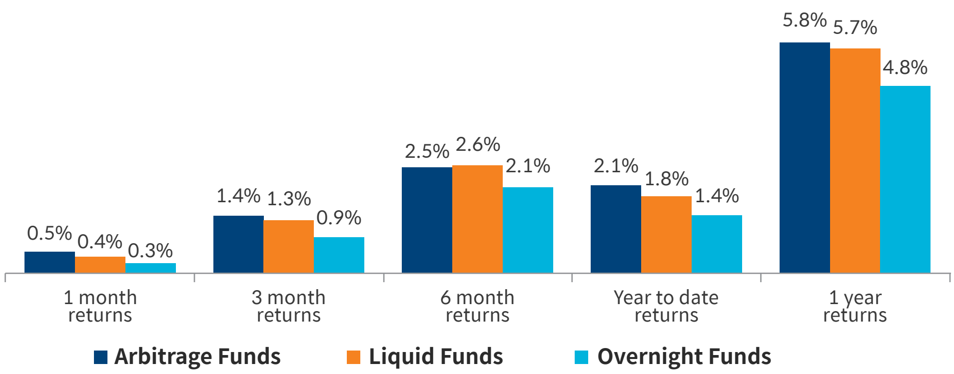
3. Arbitrage Funds versus Debt Funds

Arbitrage Funds		Debt Funds
Arbitrage fund returns depend on implied cost of carry and mispricing between cash and derivatives market	VS	Debt fund returns depend on prevailing yields and interest rate changes
Arbitrage funds are 100% hedged. credit risk may be there in the debt portfolio		Debt funds, excluding overnight funds, can be exposed to credit risk.
Equity Taxation		Debt Taxation

The chart below shows the category average returns of arbitrage funds versus liquid and overnight funds over various time-scales.

Category Average Returns (periods ending 10th May 2020)



Source: Advisorkhoj Research (10th May 2020)

Tax Advantage

A major advantage enjoyed by arbitrage funds is that of equity taxation. While profits made in debt funds held for less than 36 months is taxed as per the income tax rate of the investors, profits made in arbitrage funds held for less than 12 months (short term capital gains) is taxed at 15% plus applicable surcharge and cess. If units of arbitrage funds are sold after 12 months from date of purchase then profits (long term capital gains) of up to Rs 1 lakh are tax exempt in a financial year. Long term capital gains in excess of Rs 1 lakh are taxed at 10% only.

Conclusion - Why invest in Arbitrage Funds

- Low risk (arbitrage theoretically means risk free profits)
- Low volatility
- Has the ability to match or outperform low risk debt funds pre-tax returns
- Ideal for a few months to more than one year investment tenures
- Tax efficiency (equity taxation)

Arbitrage funds may be good investment option if one or more of the above points are part of your investment needs. You should consult with your financial advisor if arbitrage funds are suited for your short to medium term investment objectives.

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