Arbitrage Funds

Arbitrage Funds are low risk investment options for parking your short term funds instead of keeping it idle in your savings bank account at very low interest rates. Arbitrage Funds have the added advantage of being more tax efficient than debt funds like overnight or liquid funds which can also be used to park your idle funds.

What are Arbitrage Funds?

Arbitrage Funds are hybrid mutual fund schemes which aim to generate arbitrage profits by exploiting price differences of the same underlying assets in different capital market segments. These funds can also invest in debt and money market instruments. As per SEBI's directive, Arbitrage Funds must invest at least 65% of their assets in equity and equity related securities (e.g. stock futures, index futures etc). Since 65% of the assets of these funds are invested in equity and equity related securities, they enjoy equity taxation.

What is Arbitrage?

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

How does Arbitrage work?

One of the most popular arbitrage strategies is known as cash and carry arbitrage. The diagram below shows how the cash and carry arbitrage works.

Price of the same underlying stock differs in the Cash and F&O segments of the market

Premium: Futures price > Cash price	Discount: Futures price < Cash price

Cash and Futures prices converge on expiry of futures contract

On Expiry Date: Cash Price = Futures Price (irrespective of price movement)

If futures are trading at premium, fund manager can lock-in risk free profits

Selling futures in F&O market	Buying stock in cash market

Example of Arbitrage

Let us assume the price of a stock in the cash market is ₹100 and its price in the futures market is ₹102.

Share Price Movement will have no impact on the arbitrage profit

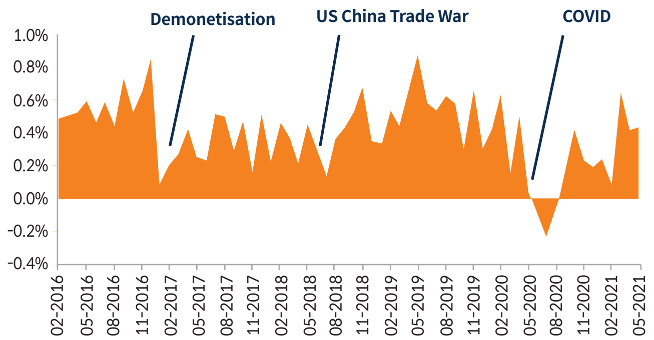
Share Price on expiry	Profit / (loss) in futures market	Profit / (loss) in cash market	Final Profit
₹90	₹(10) loss [90 – 100]	₹12 profit [102 – 90]	₹2 [12 – 10]
₹95	₹(5) loss [95-100]	₹7 profit [102-95]	₹2 [7 – 5]
₹100	Nil [100 – 100]	₹2 profit [102 -100]	₹2 [2 – 0]
₹105	₹5 profit [105 – 100]	₹(3) loss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

Disclaimer: Table above is purely illustrative

You can see that arbitrage profit is the same whether the share price moves up or down. Investors who are interested in knowing more about arbitrage should know that arbitrage is theoretically possible even if futures are trading at discounts. In that case, you will have to do the opposite trades i.e. buy futures and sell in the cash market. However, since naked short-selling has been banned in India by SEBI, such a trade is not possible under current regulations.

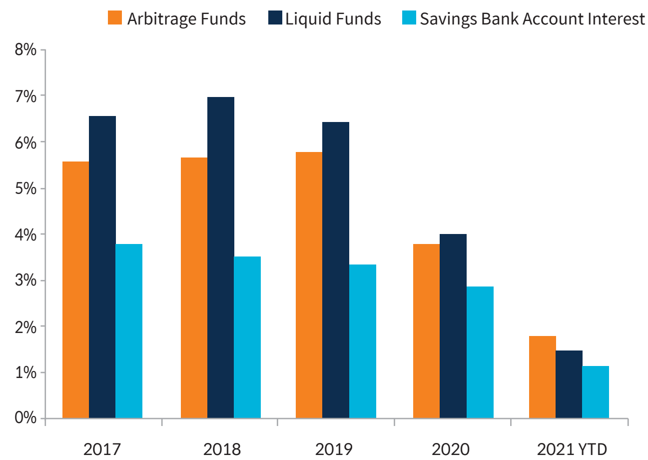
Arbitrage returns depend on market conditions

Investors should understand that mutual funds are market linked products and cannot give assured returns. Though Arbitrage Funds are low risk investments, their returns can vary depending on market conditions. The chart below shows the monthly returns of Nifty 50 Arbitrage Index from 1st January 2016 to 31st May 2021. You can see that, monthly returns were low in bearish market conditions. In extreme market conditions (e.g. COVID-19 first wave), returns may even be negative for a few weeks. Average and median monthly return of Nifty 50 Arbitrage Index over the last 5.5 years was 0.4% (around 5% annualized return), which is higher than savings bank account interest rates on a post tax basis (we will discuss tax implications in details later). However, you should be prepared for short term volatility and remain invested for at least 1 – 3 months in Arbitrage Funds.



Source: National Stock Exchange, Advisorkhoj Research (Period: 01.01.2016 to 31.05.2021).
Disclaimer: Past performance may or may not be sustained in the future.

Performance of Arbitrage Funds versus Savings Bank Account



Source: State Bank of India, Advisorkhoj Research (as on 31st May 2021). Arbitrage and Liquid Fund returns are category averages. Savings bank interest is the average interest for the year.
Disclaimer: Past performance may or may not be sustained in the future.

Taxation Advantage

Let us assume that Investor A has ₹20 lakhs in his savings bank account. The bank pays 4% interest on savings bank account balance. Investor B invested ₹20 lakhs in an arbitrage fund. Investor C invested the same in a debt fund. All are in the 30% tax bracket. Let us compare their post tax returns.

Particulars	Investor A (Savings Bank)	Investor B (Arbitrage Fund)	Investor C (Debt Fund
Investment	20,00,000	20,00,000	20,00,000
Interest rate / Return	4.0%	4.0%	4.0%
Investment tenure (months)	6	6	6
Interest / Profit	40,000	40,000	40,000
Exemption u/s 80TTA	10,000	-	-
Income / STCG Tax	9,000	6,000	12,000
Investment tenure (months)	13	13	13
Interest / Profit	86,667	86,667	86,667
Exemption u/s 80TTA	10,000	-	-
Exemption under LTCG	-	1,00,000	-
Income / LTCG Tax	23,000	-	26,000

Disclaimer: Table above is purely illustrative. Consult with your financial advisor to know the tax consequences of your investment.

*The investment amount, rate of return and investment tenure have been assumed to be constant for all investment types.

Why invest in Arbitrage Funds?

- No price risk, since the equity exposure of Arbitrage Funds is completely hedged.
- Unlike liquid funds, there is no credit risk in Arbitrage Funds.
- There is no counterparty risk since the settlement of all future contracts like these are guaranteed by the stock exchange.
- Potential of getting higher returns than savings bank interest.
- Advantage of equity taxation.

Know Risks of investing in Arbitrage Fund

- Arbitrage Funds can invest up to 35% of their assets in debt or money market instruments. These instruments may carry credit risks. Check the credit quality of the debt portion of Arbitrage Funds.
- The returns of Arbitrage Funds depend on market conditions. In extreme bear markets, futures may trade at a discount to cash prices. Since short selling is not allowed in India, arbitrage is difficult in extremely bearish conditions.
- Since cash and futures positions in Arbitrage Funds are marked to market, there may be days when the NAVs of these funds can fall. Investors need to have sufficiently long investment horizons; at least 1 month for Arbitrage Funds.

Who should invest in Arbitrage Funds?

- Investors who want higher returns (compared to savings bank) on their short term funds.
- Investors who want very low risk for their investment.
- Investors in higher tax brackets who want to take advantage of equity taxation.
- Investors who have investment tenures of at least 3 month or longer. Arbitrage Funds may not be suitable for just a few days or weeks.
- Investors should consult with their financial advisor if Arbitrage Funds are suitable for them.