GET STABLE RETURNS# AND TAX EFFICIENCY WITH ARBITRAGE FUNDS

#This category of funds helps you generate stable returns by capturing the price differential between cash and derivative markets, while maintaining tax-efficiency of equity investments.

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What is an Arbitrage Fund?

Arbitrage fund is a mutual fund category that capitalizes on the difference in price of equities in the cash and derivative markets for generating returns. The arbitrage concept works on the mispricing of assets across different markets due to the underlying inefficiencies in market pricing.

How do they work?

Let's take an example: At the start of August, Fund A buys Reliance Industries Ltd. (RIL) shares for Rs. 1,000/share and sells RIL August futures at Rs. 1,020.

(Price in Rs.)

Type of instruments	Scenario I	Scenario II
RIL share price at settlement	1030	980
Cash segment profit/loss	30 (1030-1000)	-20 (980-1000)
Future exposure profit/loss	-10 (1020-1030)	40 (1020-980)
Profit/loss on purchase of stock futures at	20	20

In Scenario I, RIL shares skyrocket to Rs. 1030 on the settlement date. At this point, the price will be nearly the same in the equity and futures markets. So when you sell the stock, a profit of Rs. 30 is earned. However, you also buy back the stock future thereby incurring a loss of Rs. 10. End result, a net profit of Rs. 20 is earned. The same thing happens even in Scenario II where the share price crashes to Rs. 980. You still end up with the same profit.

So four transactions have taken place - buy stock, sell futures, sell stock, buy futures. In this manner, irrespective of the share price, the investor earns the spread between the purchase price of equity shares and the sale price of futures contract. In other words, it is irrelevant whether the share price of RIL has risen or fallen, one would still make the same amount of money. This happens because on the date of expiry (settlement date) the price of equity shares and their stock futures will tend to converge.

ARBITRAGE FUNDS

(Open-ended Equity Schemes)

What is the risk involved?

Completely hedged positions, neutralises market risk (volatility) and targets absolute returns irrespective of market conditions.

The moderately low risk nature of the returns is the USP of the product. But this is not where the meat lies; the real attraction of Arbitrage Funds is in post-tax returns.

What tax advantages do Arbitrage Funds enjoy over other comparable fixed income instruments?

In the Union Budget '14, the government increased the long-term capital gains period on non-equity oriented funds from 12 months to 36 months and fixed the capital gains tax at 20% with indexation. Short-term capital gains on debt funds are added to one's income and taxed as per the individual's income tax slab.

On the other hand, Arbitrage Funds are categorised as equity funds from a taxation perspective. This gives Arbitrage Funds the benefit of zero taxes on long-term gains (holding period of more than a year). If the holding period is less than a year, capital gains (short-term) are taxed at 17.7675 %.

So compared to debt funds, Arbitrage Funds have a better tax advantage. Moreover, dividend distributed is not subject to dividend distribution tax and is tax free in the hands of the investor.

The moderately low risk nature of Arbitrage Funds although equity categorization for taxation gives it a clear advantage over other comparable fixed income instruments. The ideal time horizon for investing in these funds is one year or more to avail the tax advantage.

Resident individuals/HUF$*	Arbitrage Funds	Liquid/Debt Funds
Dividend income	Nil	28.840 %#
Capital gains		
Short term@	17.7675 %	35.5350 %^
Long term@@	Nil	23.690 % (Listed & Unlisted Units)
NRI $$*		
Dividend income	Nil	28.840 %#
Capital gains		
Short term@	17.7675 %	35.5350 %^
Long term@@	Nil	11.845 % (Unlisted Unit) 23.690 % (Listed Unit)
Domestic companies$$$*		
Dividend income	Nil	34.608% #
Capital gains		
Short term@	16.5315 % or 17.304 %	33.063 % or 34.608 %
Long term@@	Nil	22.042 % or 23.072 %

*Inclusive of applicable surcharge and education cess.

^ - Assuming the investor falls into the highest tax bracket.

@ Short-term capital gains will be considered for equity & Arbitrage Funds/assets held for a period of up to 12 months and up to 36 months in case of liquid and debt funds/assets.

Dividend Distribution tax applicable is payable by the Scheme.

@@ Assets not falling under short term assets will be treated as long-term assets.

$ - Surcharge at the rate of 15% is levied in case of individual/ HUF unit holders where their income exceeds Rs 1 crore.

$$ - Short-term/long-term capital gain tax will be deducted at the time of redemption of units in case of NRI investors only.

$$$ - Surcharge at the rate of 7% is levied for domestic corporate unit holders where the income exceeds Rs. 1 crore but is less than Rs. 10 crores and at the rate of 12% where income exceeds Rs. 10 crores.

Note: The information set out is as per prevailing tax laws, which are subject to change. The information is neither a complete disclosure of every material fact of Income-tax Act 1961 nor does it constitute tax or legal advice. In view of the individual nature of the tax consequences, each investor is advised to consult his/her own professional tax advisor.

Arbitrage Funds in a nutshell:

- An alternative to liquid funds and/or debt funds with low maturity.
- Moderately low risk investments due to completely hedged positions.
- Hedging ensures that the investors will earn the spread between the spot and futures markets, independent of market movements as the price of the equity shares and their stock futures will tend to coincide at the time of the settlement of the futures.
- The gains by investing in these funds are tax-free after one year or concessional tax rate within one year because they are classified as equity-oriented mutual funds from a taxation perspective.
- Dividend income is tax-free in the hands of the investor.

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