Arbitrage funds: Zero risks, Good returns

by

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- Wanted to indulge in Equity shares WITHOUT RISK? But ensuring you get returns? Invest in Arbitrage Funds of Mutual Fund Houses. They engage in riskless transactions and yet deliver Returns. They are often compared to Debt funds (Short term). Their Returns are more than Debt funds.

Arbitrage & Debt Funds' NAV Compared over 235 days (31-Oct-12 to 31-Oct-13)

NAV indexed to Re.1

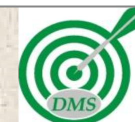
1.1
1.08
1.06
1.04
1.02
1
0.98
0.96
0.94

1 11 21 31 41 51 61 71 81 91 101 111 121 131 141 151 161 171 181 191 201 211 221 231 241

Days 1 - 235

ARBITRAGE

DEBT Both assumed starting Re.1 on Day 1



Short term Debt funds – similarity of appeal to investors

- Arbitrage funds get usually compared with Short term Debt funds as Investors in both these funds seek moderate returns with low risk. Apart from that the basic transaction in a typical ‘arbitrage’ is very short term – the transaction each month lasts till the (approximately) month-end and hence the ‘short-term’ characteristic.
- In a sense Arbitrage often earns the ‘profit’ by doing two transactions simultaneously: the Cash and the Futures where the profit is the difference between their two prices. When you transact for a future date, there is ‘interest’ that needs to get added. This gives it a similarity to Short term Debt funds.
- Are Arbitrage funds ‘low risk’? Yes, one could even say that whilst Debt funds are considered ‘low-risk’; Arbitrage funds are ‘riskless’.

Benchmark: Liquid fund index

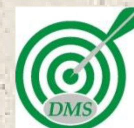
- Each Fund must specify a Benchmark against which to compare. Arbitrage funds are Benchmarked against indices such as Crisil Liquid Funds Index. They generally have outperformed the Benchmarks as shown in the case of Kotak Equity Arbitrage Fund:

FUND	1 - YEAR RETURN PERIOD ENDED (%)		
	30TH SEPT.'13	30TH SEPT.'12	30TH SEPT.'11
KOTAK ARBITRAGE	8.70	9.11	8.30
CRISIL LIQUID FUND INDEX	8.54	8.69	7.77

Higher & Steadier Returns

- Comparing the Arbitrage funds with the Debt Short term funds, the Returns are better and the volatility lower.
- The Expense ratio of Arbitrage funds will be much higher than Debt funds as there is much more work/transactions involved. When the Returns are compared, the performance of Arbitrage is superior *after considering the higher Expense ratio*.
- The comparison has been done for two Kotak funds:

FUND	1 - YEAR RETURN PERIOD ENDED			3 years'	3 years’
	30TH SEPT.'13	30TH SEPT.'12	30TH SEPT.'11	AVG	STD.DEV
KOTAK ARBITRAGE	8.7	9.1	8.3	8.70	0.41
KOTAK BOND SHORT TERM PLAN	7.2	9.6	6.4	7.72	1.71



Consistency across Arbitrage funds of various Houses

- Comparing the Arbitrage funds of IDFC and SBI, the pattern is consistent in terms of magnitude of Returns and Volatility of returns:

FUND	1 - YEAR RETURN PERIOD ENDED			3 years'	3 years
	30TH SEPT.'13	30TH SEPT.'12	30TH SEPT.'11	AVG	STD.DEV
KOTAK ARBITRAGE	8.70	9.10	8.30	8.70	0.41
IDFC ARBITRAGE FUND	8.57	9.28	8.45	8.77	0.45
SBI ARBITRAGE OPPORTUNITIES	8.70	8.90	8.30	8.63	0.31

Arbitrage funds: high churn required

- The strategy calls for very active monitoring and churn. **The 'Portfolio turnover' of Kotak Arbitrage funds is therefore as high as 324%!**
- More important, the Arbitrage funds fall in the category of Equity funds. **The tax advantage for equity category funds is that the sale of the units after one year is not liable to Long term Capital gains tax.**
- **This makes post-tax returns even more attractive than Debt funds:**

Two Growth schemes	Kotak Arbitrage	Kotak Bond Short Term Plan
NAV 30th Sept.'13	18.10	22.70
NAV 30th Sept.'12	16.60	21.20
Capital Gains	1.50	1.70
Tax on Cap. Gains (without indexing)	0	0.17
Net Cap.Gains	1.50	1.53
Return on Investment	**9.0%**	**7.2%**

Why Riskless

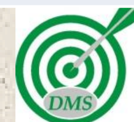
- The Arbitrage scheme invests by spotting arbitrage opportunities and there is a simultaneous purchase and sale.
- The Scheme would purchase Equity shares in the Cash segment and at the time when it purchases, it would sell Futures in the F & O segment. The Futures typically would be trading at higher rates than the cash segment based Equity shares, and therefore the difference between the Sale rate and Purchase rate is the Profit the Scheme makes. Futures price always converges to the equity share price at the close of settlement. these are closed out on Settlement date adjusting one against the other.
- Since the transaction is done concurrently, the Profit is 'Locked-in' (guaranteed). (The positions are reversed on Settlement date).
- Why the difference between the Cash and the Futures market? Futures = Cash for a Spot transaction + interest element since it is a transaction today relating to a future date. The profit is therefore comparable to the 'interest'. It is called 'cost of carry'.

How the Profit is made

Kotak has a 13.47% weight on Banks in its Portfolio. Taking the Industry "Banks", the example has been taken of Yes Bank which has highest weight in its "Banks"Portfolio. The economics is worked with deals in Cash and Futures.

- Purchase in Cash Segment 1 share: Rs.369
- Sale 1 No. Futures expiry on 28th Nov.'13: Rs. 372.5

Item	Segment	Traded (Opening price)	Cost/revenue after Transaction cost	Remarks
Purchase	Cash segment	369.00	369.18	Taken @ .5% including Serv. Tax, STT
Sale	F & O	372.50	372.31	
Profit			3.13	28 days
Profit annualised			8.83%	



Superiority over Plain Debt funds

- **Apart from the ‘cost of carry’ built in the transaction, the Fund manager also has an opportunity to better his profits. If the gap between the equity and futures decreases unexpectedly, he can immediately unwind to earn higher returns.**
- **The example given about the Yes Bank deal gives the computation of Annualised profit. If the investor holds the Fund units for over a year, he does not pay any Capital gains tax. But if he were to do the Arbitrage transaction himself he would be paying tax applicable to Short term. This is the advantage of investing in a Mutual fund.**

Debt funds lose their sheen

- The performance of Arbitrage funds have been superior to Debt funds in the past three years.
- This is despite the fact that the last three years have seen falling interest rates leading to Capital gains for persons invested in debt funds.
- Now the scenario is different thanks to the sharp depreciation of the rupee in relation to the US $.
- The expectations are that rate cuts may not be likely; if anything rates could be upped.
- *This makes Debt funds second grade alternatives.*
- In this context investment in Arbitrage funds is more sensible.

Debt funds: Jan.'10 to Aug.'13 Analysed
(Source: Morning star dated 6-9-13)

Table1: Impact of changing interest rate scenario on the performance of various debt fund categories

Group/Investment	Phase 1 - rising interest rate scenario	Phase 2 - falling interest rate scenario	Phase 3 - performance after RBI's measures to curb volatility in rupee
	(Jan 2010 - Oct 2011)	(Nov 2011 - June 2013)	(July 2013 - Aug 2013)
Liquid	6.77	9.19	1.39
Ultrashort Bond	6.79	9.30	0.56
Short-Term Bond	6.77	9.91	-1.52
Short-Term Government Bond	4.83	8.43	1.27
Intermediate Bond	5.38	11.32	-3.81
Intermediate Government Bond	4.64	12.12	-5.15
Long-Term Government Bond	3.72	13.42	-6.66

Returns in %. Returns over 1 year are compounded annualised

Comparison of Best performers

- The best amongst Arbitrage, and Short term Debt funds are compared.
- The analysis shows how Arbitrage is better.
- The Returns considered are post-tax taking the benefit of Capital gains tax exemption for Arbitrage funds:

Debt – short term	**Crisil rank**	**Returns as on 1st Nov.'13**	**Arbitrage**	**Crisil rank**	**Returns as on 1st Nov.'13**
Sundaram Debt STP AP	1	10.3%	ICICI Pru-Equity-Arbitrage-Retail	Not Ranked but Best compared with Peers	10.0%
Post tax returns		**9.3% (Held > 1 year, not indexed)**			**10.0%**

Nothing 'arbitrary' about Arbitrage funds

- **Investors seeking returns with low risk may have been loyal to debt funds so far**
- **But Interest rates which were being dropped by the RBI for the last three years may no more be reduced.**
- **With the change in the Interest rate regime scenario the Debt funds would lose that attraction.**
- **The best alternative then would be to consider Arbitrage funds.**

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