Arbitrage funds

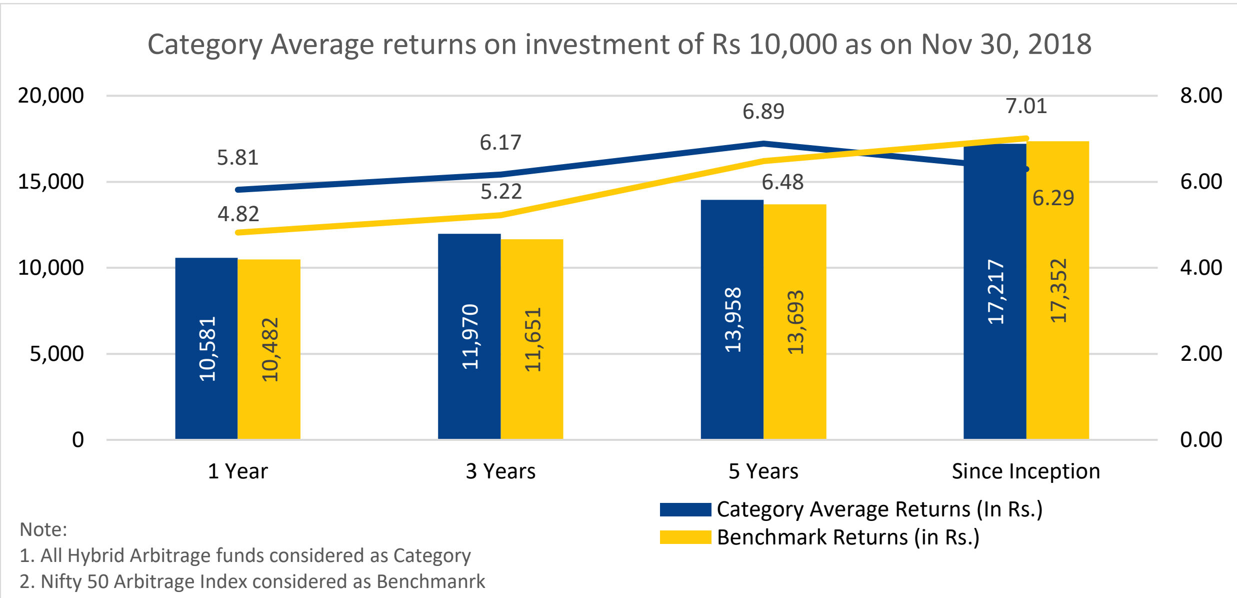
Arbitrage funds are a type of mutual funds that take advantage of the mispricing of equity shares. They benefit from low-risk buy-and-sell openings in the futures and contracts market. This is done by the fund manager by buying shares from the cash market and selling in the futures or derivatives market at the same time. The differential in the cost and sale generates the returns. Risk-wise, arbitrage funds may be similar to debt funds. As per the Securities and Exchange Board of India’s categorisation mandate, arbitrage funds should invest a minimum 65% in equities or equity-related instruments.

How arbitrage funds work?
Let’s understand the working of an arbitrage fund through an example.

The price of a share of Company A in the cash market is Rs. 1000 and in the futures market is Rs. 1025. The fund manager would buy a share from cash market at Rs. 1000 and short a futures contract to sell at Rs. 1025. At the end of the month when the prices match, the manager sells the share in the futures market and garners a profit of Rs. 25.
Again, if the manager senses prices could fall, he shorts shares in the cash market and inks a long contract in the futures market. He will short sell in the cash market at Rs 1025. At the expiry date, he purchases the share in the futures market at Rs. 1000, earning Rs. 25.

The manager could also buy on the National Stock Exchange (NSE) and sell at the Bombay Stock Exchange (BSE) to benefit from the difference.

Who should invest?
Investors with low-risk profile and short- to medium-term financial goals interested in equities can opt for these funds by investing their surplus cash in it. Other than equities, arbitrage funds may invest a certain amount in fixed income instruments. Even here the manager makes sure that investments are in high-credit quality debt securities such as zero-coupon bonds and debentures. This diversification keeps the fund in line with expectations and balances any period of insufficient arbitrage opportunities.
If one is invested in equities then when the goal nears, a systematic transfer plan (STP) can be started to move funds slowly from equity to the arbitrage funds.



Source: MFI Explorer

What to see before investing?

Risk: The risk in arbitrage funds is on the lower side as these funds do not have direct exposure to equities. There is no counter party risk as trading is done through the futures and options market. There is also no economic risk, forex risk and inflation risk. The drawback is that when a high number of people start taking part in arbitrage, the opportunities available start shrinking, which lessens the spread between cash and future market prices.
Return: Arbitrage funds aid in making returns as the fund manager tries to generate it through price differential. As these funds may take advantage of the volatility in market, market conditions are a very important consideration.

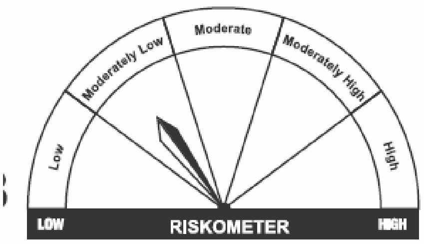
Cost: The expense ratio of arbitrage funds is on the higher side as it involves active trading. The frequent trading results in high transaction costs and thus a high turnover ratio. An exit load may apply for 30 to 60 days.

Investment period: Investors with medium to long term investment plan of say one to three years can take a look at these funds. One needs to stay invested for a minimum of three to six months to avoid exit load.

Tax: Since these funds fall under the equity category, short term capital gains for investments for a period of up to one year are taxable at 15%. Long-term capital gains tax of 10% applies on investment of more than one year and gains more than Rs. 1 lakh without the benefit of indexation.

Arbitrage funds give an investor a well-rounded portfolio as they take advantage of future and spot market opportunities, but one should keep all the parameters in mind before investing.

Riskometer



Investors understand that their principal will be at Moderately Low Risk

This product is suitable for investors who are seeking*

- Income over a short term investment horizon
- Income through arbitrage opportunities between cash and derivative market & arbitrage opportunities within the derivative segment of the equity market
- Risk - Moderately Low

*Investors should consult their financial advisers if they are not clear about the suitability of the product.

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MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY.