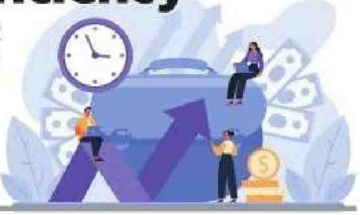
ET IN THE CLASSROOM

Using Arbitrage Funds for Tax Efficiency

Investors looking to park money for short tenures of 3-6 months and earn more than bank savings accounts with tax efficiency are moving to arbitrage funds.



WHAT IS AN ARBITRAGE FUND?

An arbitrage fund is a scheme that generates returns on the price differential in the cash and futures markets. Here, the fund manager buys the stock of a company in the cash market and simultaneously sells an equivalent quantity in the futures segment. The gain made from the two trades is the return earned. The fund manager will not take naked exposure to any individual security or an index. Each buy transaction in the cash market has a corresponding sell transaction in the futures market. As per regulatory requirements, in such a scheme, at least 65% of the corpus is allocated to arbitrage products, while the fund manager is free to choose the remaining 35% between arbitrage and debt products.

WHY ARE INVESTORS DRAWN TO THESE SCHEMES?

A rising stock market leads to higher volatility, offering opportunities for arbitrage trades. High returns compared with savings accounts and better taxation are attracting investors to arbitrage funds. High net-worth investors (HNIs) prefer these funds as they are treated as equity funds for taxation, significantly increasing their post-tax returns. Investors holding such schemes for less than a year pay 20% capital gains tax, while if they sell after a year, they pay only 12.5% long-term capital gains tax. As compared with this, in a debt fund, investors have to pay tax as per income slabs which could go up to 30% for HNIs.

HOW MANY SCHEMES EXIST AND WHAT ARE THE RETURNS?

There are currently 30 arbitrage schemes that manage ₹2.35 lakh crore of assets. As per data from Value Research, investors earned an average of 7.36% return over the last year, higher than the 7.12% from liquid funds and 6.61% from overnight funds.

WHAT ARE THE RISKS IN THESE FUNDS?

Arbitrage funds rank high on safety. The scheme always has a market-neutral position as the security bought in the cash market is simultaneously sold in the futures market. Compared with debt funds, where there could be some credit risk, there is no such risk here.

PRASHANT MAHESH