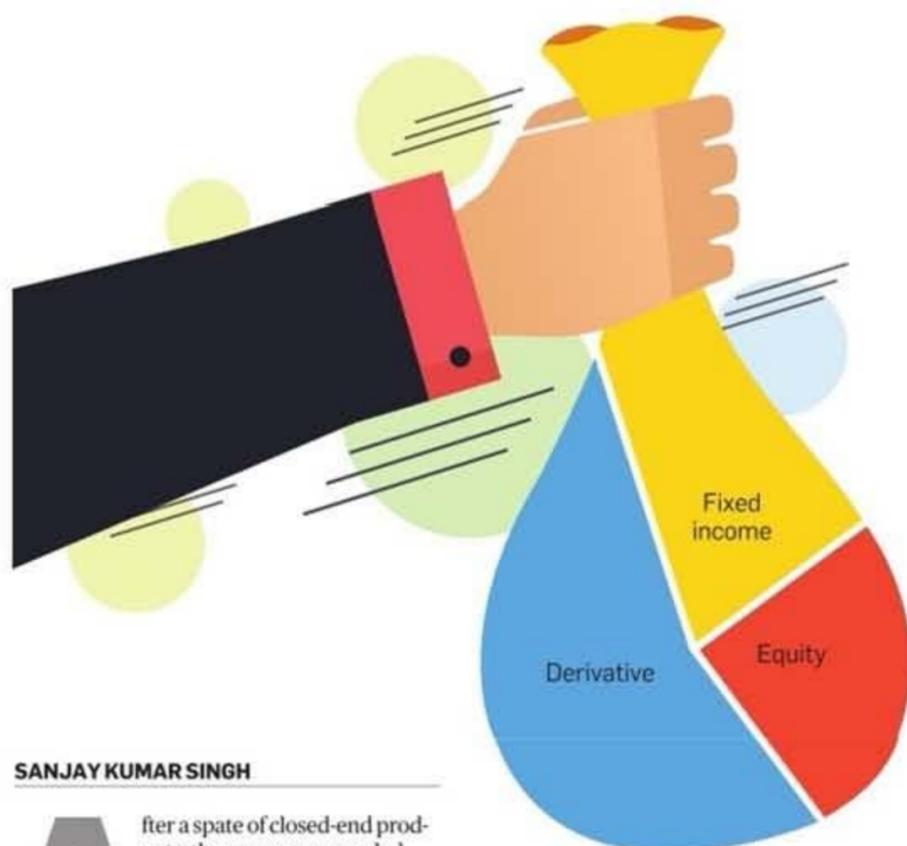


**The Economic Times****Title : These innovative hybrid funds are tax-efficient****Author : SANJAY KUMAR SINGH****Location :****Article Date : 09/29/2014**

# These innovative hybrid funds are tax-efficient

The adverse tax treatment of debt funds has led to a flurry of new funds that invest in a combination of debt, equity and derivatives. Here's how they can benefit investors.

**SANJAY KUMAR SINGH**

**A**fter a spate of closed-end products, three new open-ended funds have been launched by JP Morgan, Kotak and IDFC AMC. These are asset allocation funds that are tax efficient. While JP Morgan India Equity Savings and Kotak Equity Savings are similar, IDFC Dynamic Equity has a slightly different investment approach.

**MIP-plus funds**

Earlier, MIPs (monthly income plans) of mutual funds were popular among conservative investors. These funds allocate about 15-25% in equities and the balance in debt. The equity component provides the kicker so that these products offer a little higher returns than bank fixed deposits and small-saving instruments. However, this year's Budget made adverse changes to the way debt funds are taxed. To be eligible for the indexation benefit on long-term capital gains, investors must now hold debt funds for three years instead of one. This has affected the popularity of MIPs.

The mutual fund industry has hence innovated. It is now offering you products that carry MIP-like risk but enjoy the tax treatment of equity funds—zero tax if your investment is for more than one year. Fund houses have kept the equity portion of an MIP intact but have replaced the larger debt portion with arbitrage. These funds will also have an allocation to debt (see table: *Betting across asset classes*). In the arbitrage portion, these

funds will take advantage of arbitrage opportunities between the cash and the futures segments of equities. The equity portion will be volatile but may offer good returns. "Fund houses are betting that if the equity markets remain positive over the long term, the equity portion could generate double-digit returns and thus augment the total returns of these funds," says Niranjana Risbood, director, fund research-India at Morningstar. The debt portion will provide regular returns while the derivative portion will contain volatility. The result: a product whose risk-return profile lies somewhere between that of debt and equities, and which enjoys the tax treatment of an equity fund. This is broadly the approach that JP Morgan's India Equity Savings and Kotak Equity Savings Fund follow.

**The quant approach**

IDFC Dynamic Equity will follow a quantitative approach to asset allocation. It will take into account the PE of the Nifty to determine its equity allocation. But to also benefit from short-term trading opportunities, it will

tweak its allocation slightly using a technical parameter. If the Nifty is trading above its 200-day moving average, it indicates that the index is on the uptrend. Hence, the allocation will be slightly higher. The allocation will be slightly lower if the index is trading below the 200-day moving average. The fund will invest in stocks that belong to either the Nifty or the Nifty Junior index. If a high market PE forces the fund house to reduce its equity allocation below 65%, it will invest in derivatives so that its allocation to equity-based instruments doesn't fall below that level.

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**Who should invest?**

Investors with a conservative approach may consider the first two funds. Says Nandkumar Surti, MD & CEO, JP Morgan AMC: "Conservative investors who are seeking to beat inflation post-tax with minimum volatility may invest in our fund." However, investors must be prepared for some interim volatility because of the unhedged equity component. Also, have an investment horizon of at least 18-24 months in these funds.

IDFC's fund will have a higher equity component and hence is better suited for long-term wealth building. "First-time equity investors, who want a rule-based approach, or even old-timers who prefer a quantitative approach, may invest in this fund with an investment horizon of at least three to five years," says Vidya Bala, head of mutual fund research, Fundsindia.com.

**A few caveats**

Your initial investment in these funds should not exceed 5-10% of your portfolio. Watch their performance for some time before raising your allocation.

Second, understand the risk-return profile of these funds. "Tax efficiency alone can't be the reason for investing in these funds. They should also help you meet your financial goals," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Third, arbitrage opportunities tend to be available only some times. When they are not available, the arbitrage portion of these funds may generate liquid fund type returns. Another risk, as Risbood points out, could also be that returns from the arbitrage portion could be low because of too many funds chasing the same few arbitrage opportunities in the markets.

## BETTING ACROSS ASSET CLASSES

**These NFOs will invest their assets in on equities, derivatives and debt.**

|                                | Equity (%) | Fixed income (%) | Derivative (%) |
|--------------------------------|------------|------------------|----------------|
| JP Morgan India Equity Savings | 20-35      | 25-35            | 55-90          |
| Kotak Equity Savings Fund      | 15-25      | 10-35            | 40-75          |

## BUYING LOW AND SELLING HIGH

**IDFC Dynamic Equity will use both PE and a technical indicator to decide on equity allocation.**

| Nifty PE band | Spot Nifty >200 DMA | Spot Nifty <200 DMA |
|---------------|---------------------|---------------------|
| Below 13.7    | 100                 | 65-83               |
| 13.7-15.7     | 83-100              | 48-65               |
| 15.7-18.4     | 65-83               | 30-48               |
| 18.4-21.3     | 48-65               | 30                  |
| >21.3         | 30-48               | 30                  |

Source: AMCs' documents

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