Are hybrid funds for you?

FOR YOUR PORTFOLIO First-time investors, who cannot handle the volatility of equity or debt funds, may consider hybrid funds, say financial planners

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MUMBAI: Would you consider investing in a product that has a combination of debt, equity and gold in it? If yes, then you have an option in the form of hybrid mutual funds. According to data from valueresearchonline.com, there are 45 hybrid funds in the market. Like any other investment instrument, you need to consider investment horizon, risk profile and investment goals while investing in hybrid funds too. Let's take a look at the different types of hybrid funds and their compositions before deciding which one to pick:

THE STRUCTURE

Hybrid funds invest in three kinds of asset classes — debt, equity and gold. According to the Securities and Exchange Board of India (Sebi) classification, there are six categories of hybrid fund. An aggressive equity hybrid fund, earlier known as balanced advantage fund, invests around 65% -75% in equity and remaining debt funds. "Funds in this category can be flexi-cap (either small-cap or mid-cap category)," said Vishal Dhawan, founder, PlanAhead Wealth Advisors.

Dynamic asset allocation or balanced advantage fund can put up to 100% in equity or debt. Here the fund managers can alter the composition. "Since the fund managers can change the composition based on market conditions, this category is slightly less volatile," said Pawan Agrawal, founder, InvestGuru.in. And based on the composition, the taxation varies.

In multi-asset fund, you will have allocation in all three asset classes. "The equity allocation is around 65%, debt 20% to 25% and the remaining in gold," said Agrawal. In equity savings funds, the equity component can range between 10% and 40% while the rest is in arbitrage and debt funds. "It has lesser longer term equity so are less volatile and attract equity taxation," said Agrawal.

In case of debt hybrid funds or conservative hybrid funds where "fund managers are managing the fund, a lot depends on the interest rates to alter the composition," said Dhawan. In debt hybrid fund, around 75-85% of the corpus is invested in debt. "The fund attracts debt taxation as there are no arbitrage funds," said Agrawal.

However, the catch with hybrid funds is that even though two funds are in the same category, it does not mean they are similar. They may have starkly different portfolio construction with varying investment allocation.

"The way the investment portfolio is constructed, defines the volatility and risk profile of the fund. For example, Mirae Asset Hybrid Equity fund invests 90% to 95% of its equity portion into large cap and most of its debt portion in short duration funds to reduce volatility. On the other hand, L&T Hybrid Equity fund invests 50% of its equity portion in small and mid-cap companies and the balance in large-cap companies. Now depending on the market volatility either of the funds performance will differ.

Even though they are in the same category, their volatility is different. "If the duration of the instruments is higher, it will be more volatile than the debt funds of a shorter duration of the same category," he added. Hence, it is important to monitor the portfolio composition in hybrid fund. "For instance, in a conservative hybrid fund, just because it is conservative it is not essential that the debt papers it invests in will be conservative," said Dhawan.

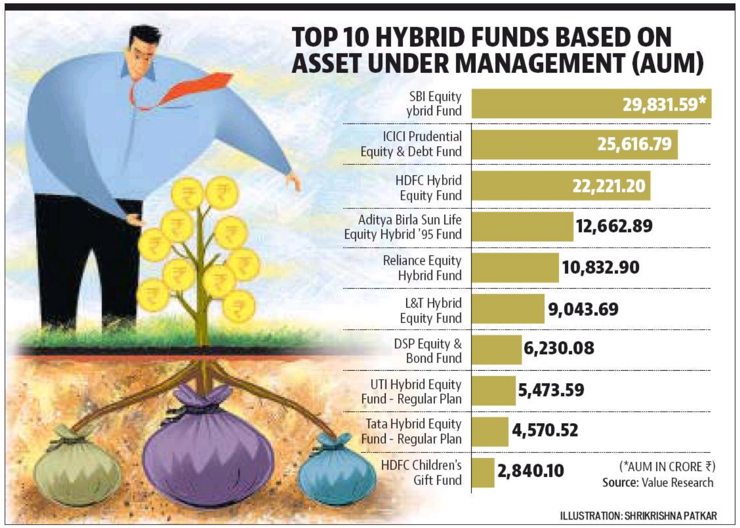

ILLUSTRATION: SHRIKRISHNA PATKAR

HYBRID FUND ATTRACTS EQUITY TAX TREATMENT IF THE EQUITY COMPONENT OVER A YEAR IS ABOVE 65%. IF THE NON-EQUITY COMPONENT IS MORE THAN 35%, IT ATTRACTS DEBT TAX TREATMENT

THE COST

All mutual funds attract charges in the form of expense ratio. "If you look at any category of hybrid fund and compare it with buying a debt or an equity fund separately, the latter option will turn out to be cheaper than buying a single hybrid fund," said Dhawan. Let's assume the expense ratio for equity funds is 1.75% (a mid-point of the range 1.5 to 2%) and expense ratio for a debt fund is 0.5% (a mid-point of the range 0.5 to 1%) while for a balanced advantage hybrid fund is 1.75% (a mid-point of the range 1.5 to 2%). Say you invested ₹1 lakh. The cost for the hybrid fund will be ₹1,750.

For instance, if you invest ₹50,000 in a debt fund where your expense would have been ₹375 and ₹50,000 in an equity fund where your expense would be ₹875, then your total expense would be ₹1,250. "This difference in amount shows the advantage of keeping your funds separately," said Dhawan.

WHAT SHOULD YOU DO?

"If you are investing in hybrid funds, it is assumed that you are looking for lesser risk," said Agrawal. It works for first-time investors and for those who are not looking to handle their own asset allocation.

"First-time investors, who can't handle the volatility of equity or debt funds can look at hybrid funds. Investors who don't do their asset allocation and are comfortable with fixed allocation, can look at hybrid funds," said Dhawan. You should look at factors such as returns, volatility, your tax slab and risk profile. It's not possible for you to expect zero volatility because almost all funds will have equity exposure.