The new paradigm for hybrid funds to adopt

Under the new norms of Securities and Exchange Board of India (Sebi) for fund categorization, which will become applicable over the next few months, all funds categories will go through changes—both from the perspective of fund structuring and investors. The categories of debt funds and hybrid funds are likely to see the most changes. Here's a look at the changes and implications for the hybrid category, which has various types of asset sub-classes.

For starters, the nomenclature, or fund description, has been changed for certain categories—and rightly so. The term Monthly Income Plans (MIPs) rings a bell with conservative or fixed-income oriented investors. However, in reality it is a way of allotting 10-25% equity to the fund portfolio. For all you know, some investors may not be aware that they are taking partial exposure to equities. The new name for this category of funds is 'Conservative Hybrid Funds'.

The other change in nomenclature is for balanced funds. If we go by the simple English connotation of the term 'balanced', to the uninitiated it implies 50:50 allocation to equity and debt. In reality, in a balanced fund the allocation to equity is 65% or more, so that it becomes eligible for the tax efficiency of equity funds. Nothing wrong in that. However, for the not-so-savvy investors the nomenclature is misleading. Now, mutual funds can offer either a 'Balanced Hybrid Fund' or an 'Aggressive Hybrid Fund'. This is a better way to communicate than only calling these 'Balanced Funds'.

In terms of fund composition, for 'Conservative Hybrid Funds' the equity allocation has been defined as 10-25%, which gels well with the name of the category. The equity component of a 'Balanced Hybrid Fund' will be 40-60%. The implication is that this category will be taxable as debt funds, since the equity allocation is less than 65%. It is mentioned that no arbitrage would be permitted. Fund managers try to generate tax efficiency for investors by investing in cash and futures segments of the equity market. This is counted as equity investment from the tax treatment perspective, but it is market-neutral—which means, equity market movements do not take away from the returns of the fund. In the 'Aggressive Hybrid Fund' category, equity exposure is defined as 65-80%, hence it will qualify for tax efficiency of equity funds.

The asset management company (AMC) can have a fund in either of the two categories (balanced or aggressive), not both.

In the new scheme of things, the AMC has to decide whether it wants to offer a tax-efficient fund to investors (a fund with equity component more than 65%) or a 'pure' balanced fund (with about 50:50 allocation to equity and debt) that will be tax inefficient.

The market cap of the equity component has not been defined, such as: large-, mid-, small- or multi-cap. In the recent equity market correction, some balanced funds with 65-75% equity allocation declined more than equity funds per se. The reason was that mid-cap stocks are more volatile than large-cap ones and a few balanced funds with higher mid-cap allocation corrected more. The regulator is taking care of investors by defining equity allocation in the two categories—40-60% or 65-80%. The volatility is expected to be in a proportionate range. But a balanced fund with 50% of the portfolio in mid- or small-cap stocks can potentially be more volatile than a balanced fund with 70% invested in blue-chip stocks.

This is relevant from the perspective of borderline equity-oriented investors, who would like to participate in the India growth story but are wary of the current stretched valuations. The mindset is, 'I am taking 65% exposure to equities and not 100%, hence volatility is contained to that extent.' Sebi may like to give a thought to this aspect.

On the taxation aspect as well, the regulator's approach has always been that product construct should not be tweaked to make it tax efficient; it should be done only from the perspective of product merit. This approach has its advantages but it does not harm to allow, say, 10% arbitrage in a Balanced Hybrid Fund. Returns from cash-futures arbitrage are similar to, or marginally lower, than debt returns. The rationale is that the tax efficiency generated by virtue of being treated as equity fund is significant, at least as long as tax laws permit.

The other hybrid categories are 'Dynamic Asset Allocation' or 'Balanced Advantage' with no restrictions on portfolio construct; 'Multi-asset Allocation Funds' with minimum 10% each in minimum of three asset classes; 'Arbitrage Funds' with minimum 65% in equity arbitrage and 'Equity Savings Funds' with minimum 65% allocation to equity. Arbitrage and Equity Savings Funds will be treated as equity for tax purposes, as long as tax laws don't change.

Net-net, the new paradigm leads to clarity for investors on the fund mandate. Investors need to attune to the right horizon and risk appetite for the respective category, for example, 'Conservative Hybrid' being defensive and 'Aggressive Hybrid' being aggressive.

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