# Navigating the World of Hybrid Funds

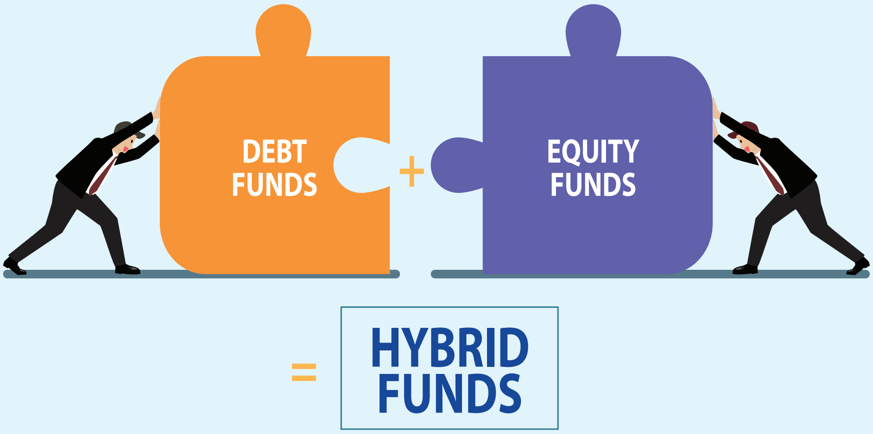
**There is a lot to choose from hybrid funds. Know the many types and how they function to choose the one that meets your needs**

Seasoned investor understands that exposure to equities has a high chance of experiencing volatility and even short-term losses, considering the real-time movement of stock markets. At the same time, every mutual fund investor seeks to optimise returns with minimal investment risk. The hybrid fund category exists to address such a need by providing options to investors by way of optimally managing investment risk and returns. Hybrid funds are designed to provide growth potential over time by managing volatility and investment risk. Hybrid Funds work on the principle of asset allocation to minimise the impact of volatility by investing across asset classes with low correlation like equity, debt, and gold to suit the risk appetite of investors. For instance, equity allocation allows you to participate in the upside, debt intends to provide stability and gold allocation usually acts as a hedge against fluctuation in equity and debt. By following a mix between the two with different allocations; these funds attempt to manage the impact of volatility on portfolio returns. These funds are suitable for investors who are looking for capital appreciation at a manageable risk, as these funds carry lower risk than pure equity mutual funds.

## Choice of Hybrid Funds

To ensure uniformity in the characteristics of similar type of schemes launched by different Mutual Funds, SEBI came up with the Categorization and Rationalization of Mutual Fund Schemes in 2017, detailing out the composition and variety of hybrid funds. Broadly there are 7 types of hybrid funds *(See: The World of Hybrid Funds)*. Among these categories, there is plenty to choose from for investors and there is difference between the funds given their asset allocation and risk-return potential.
For instance, the Aggressive Hybrid fund offers a high equity allocation which could range between 65 and 80%. Conservative Hybrid Funds are at the opposite spectrum of Aggressive Hybrid Funds in terms of asset allocation and risk with equity

allocation of 10-25% and 75-90% in debt instruments, hence less risky. The Balanced Hybrid and Equity Savings category have varying equity and debt allocation between the extreme ends seek to provide a moderate risk and growth prospect to investors.




## Multi Asset Category

Within the hybrid category, the multi-asset category offers a unique investment choice. Funds in this category invest a minimum of 10% of their portfolio in at least 3 asset classes (generally equity, debt and commodities like gold). They somewhat practise the philosophy of benefiting from the upside of one of the asset classes, while managing the downside risk. A mix of assets allows such funds to view the big picture with the ability to capture opportunities and mitigate risk across different economic cycles and market environments.

For investors, these funds offer a tailor-made portfolio to invest in to suit their investment objective and returns potential. Moreover, it is difficult to correctly choose the right asset class for investing, because all asset classes perform differently in a given period. This category of fund with its allocation to different classes, especially gold offers a solution to this problem.

## THE WORLD OF HYBRID FUNDS

| | Allocation | Risk Range* | Taxation |
|---|---|---|---|
| **Conservative Hybrids** | • **Equity & Equity related instruments:** 10%-25% of total assets<br>• **Debt instruments:** 75% - 90% of total assets | Moderate - Moderately High | As applicable to debt funds |
| **Balanced Hybrid** | • **Equity & Equity related instruments:** 40%-60% of total assets<br>• **Debt instruments:** 40% - 60% of total assets<br>• No arbitrage permitted in the scheme" | Moderately High - High | As applicable to debt funds |
| **Aggressive Hybrid** | • **Equity & Equity related instruments:** 65%-80% of total assets<br>• **Debt instruments:** 20% - 35% of total assets in debt instruments | High | As applicable to equity funds |
| **Multi Asset Allocation** | • Funds that invest a minimum of 10% of their portfolio in at least 3 asset classes (equity, debt and commodities like gold) | High | As applicable to equity funds if they maintain 65% or more equity allocation |
| **Arbitrage** | • **Equity & Equity related instruments:** Minimum 65% of total assets following an arbitrage strategy | Low | As applicable to equity funds if they maintain 65% or more equity allocation |
| **Equity Savings** | • **Equity & Equity related instruments:** 65% of total assets<br>• **Debt instruments:** 10% of total assets in debt instruments<br>Minimum hedged & unhedged to be stated in the SID and Asset Allocation under defensive considerations may also be stated in the Offer Document | Moderate | As applicable to equity funds |
| **Dynamic Asset Allocation or Balanced Advantage** | • Investment in equity/ debt that is managed dynamically | Moderately High - High | As applicable to equity funds if they maintain 65% or more equity allocation |

Classification as per SEBI Categorization of Funds 2017; *Check Riskometer of each specific scheme to choose the fund based on your risk profile.

## Arbitrage funds

This type of hybrid fund generates return by using the strategy of simultaneously buying and selling of securities in different markets to take advantage of different prices. The advantage of following such a strategy is that there is minimal stock market risk when investing with such a strategy because the buying and selling price of a stock is known to the fund manager.

The arbitrage strategy is used by evaluating the price difference in the price of a security in the spot and the futures market. If the price is higher in the spot market, the fund manager buys the security in the futures market. At the same time, the fund manager will sell the same quantity of the security in the spot market. The difference between the prices of the security in both the markets is the gain, excluding other costs. The arbitrage strategy minimises investment risk, thereby providing investors in such funds the upside of equity investments at a lower risk.

The 'Theory of Loss Aversion' by Daniel Kahneman and Amos Tversky, expresses investor concerns very nicely. The pain of losing is psychologically about twice as powerful as the pleasure of gaining. After all, no one wants to lose money when investing. Dynamic asset allocation fund is a type of hybrid fund which has used this investor concern to its advantage in building an investment approach. Investors who wish to see lower volatility in the long run may choose to invest in dynamic asset allocation funds *(See: Understanding Dynamic Asset Allocation Funds)*.

## TAXATION OF MUTUAL FUND SCHEMES

| | Debt oriented schemes | Equity-oriented schemes* |
|---|---|---|
| **Short Term Capital Gains (STCG)** | Slab Rate | 15% |
| **Holding period for STCG** | 36 months or less | 12 months or less |
| **Long Term Capital Gains (LTCG)** | 20% after indexation | 10% |
| **Holding period for LTCG** | More than 36 months | More than 12 months |
| **Dividend taxation** | Dividend is taxable in the hands of Investor and TDS will deducted if dividend exceeds Rs 5,000 | Dividend is taxable in the hands of Investor and TDS will deducted if dividend exceeds Rs 5,000. |

* Long-Term Capital Gains from sale of equity shares and equity-oriented mutual funds are taxed at 10% (without the benefit of indexation) if an individual's total capital gains exceed Rs. 1 lakh in a financial year.

### Tax implications

That hybrid funds could be equity-oriented or debt-oriented; the way they are taxed depends on their type. A fund that has a minimum of 65% in equity or equity-oriented securities is deemed as an equity-oriented fund for the benefit of computing tax. All other schemes are deemed as debt-oriented funds and taxed accordingly *(See: Taxation of Mutual Fund Schemes)*. Arbitrage funds and even some of the multi-asset funds within the hybrid fund category benefit from their equity classification when taxation is applicable.

**Dynamic Asset Allocation Fund is for those who do not want to stick to a fixed asset allocation but want to move based on market changes without taking the calls themselves**

Do check on how the hybrid fund you invest will be treated for taxation on gains and plan your investment in them accordingly. However, the choice of fund should not be driven only on taxation; it should be based on your need and the fund's suitability to your financial goal and risk profile.

## Advantage with Hybrid Funds

All types of mutual funds have advantages to invest; however, hybrid funds as a category provide you with a good combination of asset classes such as equity, debt and commodities. Let us explore some of these benefits.

***Defined asset allocation mix:*** You get to invest in at least two different asset classes in a stated allocation of equity and debt.

***Diversification:*** Investing in equity and debt is natural for hybrid mutual fund, however, a fund manager has the flexibility to further allocate a portion of the equity to small-cap, mid-cap, and large-cap stocks to bring in more diversification and lower the risk. Likewise, the allocation to debt could be across a variety of permitted debt instruments.

***Dynamic management:*** Hybrid fund managers have the flexibility to move investments across asset classes as stated in the mandate of the fund that they manage – they actively rebalance portfolios, which is desired for optimal performance of the fund.

***Suitable to risk appetite:*** Whatever your investment risk profile, there is a chance for a hybrid mutual fund to meet your risk profile. For instance, equity would suit a risk taker, while a conservative fund would suit someone wishing for low risk.

### Who Should Invest in Hybrid Funds?

Hybrid Funds are gaining acceptance among all types of investors as indicated in the data on assets inflow into this category in recent years. These funds are suitable to all investors as the choice of funds ranges from low risk to high risk category. Investors seeking growth or income could also consider investments in these funds, as these funds invest within a range in equities.

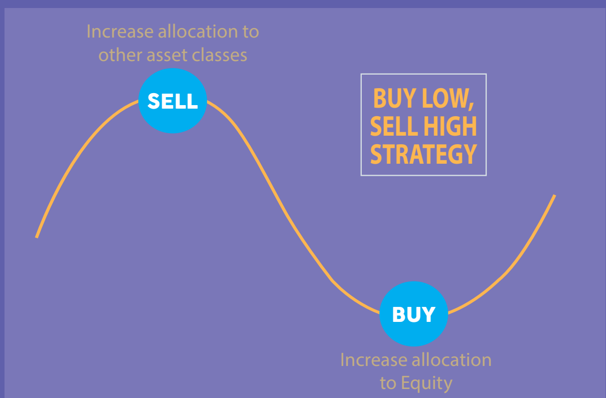
Hybrid funds are mostly suitable for first-time investors, limiting their exposure to equity and providing adequate security against fluctuating stock markets. Investments in such funds also allow them to learn the behaviour of the equity market while limiting their risk exposure. One has the

# Understanding Dynamic Asset Allocation Funds

Most investors look to construct an investment portfolio that fits their individual risk tolerance and investment goals. Many manage to create such as portfolio too, but it is not enough to construct it and forget it. A fundamental need for optimum returns from a portfolio is to ensure that the portfolio stays balanced, that is the allocation across asset classes is maintained by way of rebalancing the portfolio. There are tomes written on the benefits of portfolio allocation and rebalancing, because rebalancing your portfolio allocation allows you to maintain your desired level of risk over time.

Portfolio rebalancing is necessitated because portfolios naturally get out of balance as the prices of individual investments fluctuate over time. One can rebalance their portfolio at predetermined time intervals or when the allocations deviates a certain amount from the ideal portfolio mix. Rebalancing can also be done by either selling one investment or buying another or by allocating additional funds to either stocks or bonds. While the steps to rebalancing an investment portfolio may seem easy; actually putting it to practise is a tough task.

The category of dynamic asset allocation funds (DAAF) plays an important role in dynamically managing the asset allocation of the fund. There is no cap on the equity or debt exposure in these funds as the operating principal is left to fund managers. Investments in such funds can swing from no equity/debt exposure to 100% equity/debt exposure as defined in the fund's documents. However, the allocation to asset classes are as mentioned in the stated investment documents including the strategy adopted by the fund manager to manage the dynamic asset allocation.




Some of the strategies adopted by fund managers managing DAAF follow timeless tenets such as buy low and sell high, buy and hold for the long-term, buy cheap when the valuations are low, exit equities when the valuations are high and combination of such approaches. Mostly, debt allocation is used as a rebalancing exercise with sometime positions built to take advantage of change in interest rates. Most DAAF models are based on Price to Earnings Ratio, Price to Book ratio, GDP data and interest rate movements.

These funds have become funds for all times – market downs and ups. These are also suitable for almost every type of investors, mainly those desiring lower volatility, and for almost every state of the market. With the fund manager taking the decision based on DAAF models on when the market is low or high it makes easy for investors to just stay invested over market cycles than worry over market fluctuations. Similarly, the decision on allocation to equity and debt is also taken based on the fund house investment model, which makes investment decisions fairly automated and driven by set investment parameters.

Investors should look for the asset allocation and balancing approach used by the fund when choosing a DAAF. If one is new to investing, DAAF makes for a good start, though even seasoned investors seeking stable returns and low volatility may benefit from investments in this type of hybrid fund.

choice of investing in lump sum as well as through SIP (systematic investment plan) when investing in these funds for optimum outcomes. If the investment horizon is for the long-term, invest through SIPs with additional lump sums from time-to-time if possible.

The main advantage of a hybrid mutual fund is that it allows investors with basic investment strategy of following asset allocation and diversification. Most of the funds in this category are suitable for long-term investments. The longer time horizon ensures stability and allows the investment to show healthy returns over time.

The performance track record of the hybrid category infuses confidence among investors to stay invested in these funds. After all; investors get peace of mind when investing in these funds without worrying about the asset allocation and diversification of their portfolio in the long run.