

# CRISIL FUND *INSIGHTS*

Monthly funds newsletter from CRISIL Research

Volume – 91 November 2018

## Arbitrage Funds: Leveraging volatility to deliver returns

### Investment thoughts

Volatility and risks are an inherent part of investing – and are the major reasons why investors often shy away from the equity markets. But what if one could leverage the inherent volatility of the stock market and turn it into an investment opportunity while hedging the risks at the same time? Arbitrage funds, a type of equity-oriented hybrid funds, do just that by taking advantage of the pricing differential or arbitrage between stocks traded in the cash and derivatives segments to generate returns.

This article looks at how arbitrage funds profit from volatility – they have delivered positive, if moderate, returns over the past one year at a time when most other equity fund categories have slipped into the red -- and how their tax treatment makes them more attractive.

Given the growing importance of arbitrage funds, CRISIL has added the category in its CRISIL mutual fund rankings from September 2018. Investors can refer to the rankings to identify the top performers in the category at <https://www.crisil.com>

#### What are arbitrage funds?

Arbitrage is nothing but the purchase and sale of an asset at the same time in order to benefit from the price differential that arises between stock prices in the cash and derivatives (futures) segment. Arbitrage funds, thus, are premised to take advantage of just such arbitrage opportunities by locking in the spreads that are available between the cash and futures market.

For example, suppose the stock price of XYZ Ltd is Rs. 600 in the cash market and its futures price (in the derivatives segment) is Rs. 620. In such a scenario, an arbitrage fund can earn by selling a futures contract of XYZ Ltd. at Rs. 620 and buy an equivalent number of shares in the cash market at Rs. 600. On the settlement date, the company's stock price and futures price would converge and the transaction can be reversed. Thus, the fund can make a clean profit from this arbitrage opportunity.

#### How they have fared

Since arbitrage funds base their returns on the spreads between the cash and derivatives market, volatility spells an opportunity for them. As most of these funds completely hedge their portfolio, they tend to provide stable returns, almost in line with shorter maturity debt funds as seen in Table 1. Over a shorter timeframe, these funds may give negative returns, but their performance typically improves with the increase in the holding period. As seen in Chart 1, the minimum returns from these funds, which were negative for holding periods of less than one month, turned positive for holding periods of over one month.

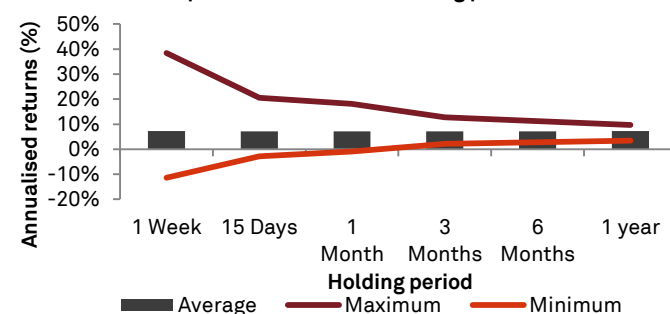
Table 1: Annualised rolling returns

Period	15 Days	1 Months	3 Months	6 Months	1 Year
Arbitrage funds	7.16%	7.13%	7.10%	7.12%	7.20%
Liquid funds	7.68%	7.67%	7.69%	7.70%	7.77%
Money market funds	7.70%	7.70%	7.69%	7.70%	7.78%
Low duration funds	7.88%	7.85%	7.86%	7.86%	7.94%
Ultra short duration funds	7.75%	7.73%	7.76%	7.78%	7.86%

Average of daily rolling returns of various holding periods between October 2008 and October 2018

Categories presented by CRISIL ranked funds as of September 2018

Chart 1: Min-max performance across holding period



Based on daily rolling returns of various holding period between October 2008 and October 2018, Category presented by CRISIL ranked funds as of September 2018

Apart from stable returns, investors can also benefit from the tax treatment of arbitrage funds. Since they invest over 65% of their corpus in equities, they are taxed as equity funds, which gives them an edge over debt funds even though equity funds are now subject to a long-term capital gains (LTCG) tax of 10% (plus surcharge and cess) for investments over one year. The short-term capital gains (STCG) tax on equity funds is 15% (plus surcharge and cess). In contrast, the STCG on debt funds is taxed at the income tax slab rate while the LTCG tax is 20% with indexation for a holding period of over three years.

#### Word of caution

By their very nature, arbitrage funds hedge between pure equity and equity futures and thereby, lock the spreads to generate moderately positive returns at all times. Investors should note that the performance of arbitrage funds depends on the arbitrage opportunities available in the equity market and any reduction in these opportunities may result in a subdued performance. Further, they also come with exit loads ranging from 0.25-0.50% for redemptions within one month. Hence, investors should consider their risk profile, liquidity needs and time horizon before investing in these funds.

## Market - Overview

Indices	% Change in October 2018	% Change in September 2018
Nifty 50	-4.98	-6.42
S&P BSE Sensex	-4.93	-6.26

Indicators	October 31, 2018	September 28, 2018
10-year Gsec	7.85%	8.02%
Monthly CPI Inflation	3.31%	3.70%

## Mutual fund - Overview

Top Stock Exposures – October 2018	Top Sector Exposures – October 2018
1. HDFC Bank Ltd.	1. Banks
2. ICICI Bank Ltd.	2. Computers - Software
3. Infosys Ltd.	3. Pharmaceuticals
4. State Bank of India	4. Refineries/marketing
5. ITC Ltd.	5. Engineering, Designing, Construction
6. Reliance Industries Ltd.	6. NBFC
7. Larsen & Toubro Ltd.	7. Housing finance
8. Housing Development Finance Corporation Ltd.	8. Cigarettes
9. Axis Bank Ltd.	9. Passenger/utility vehicles
10. Tata Consultancy Services Ltd.	10. Cement

### New Stocks Entries and Exits in Mutual Fund Portfolios – October 2018

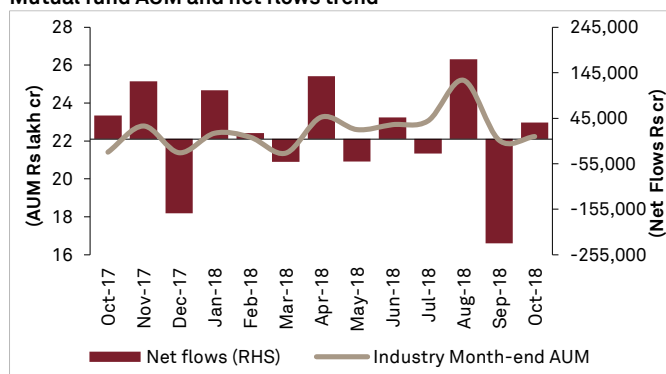
Entries	Exits
GTPL Hathway Ltd.	Autopal Industries Ltd.
Garden Reach Shipbuilders and Engineers Ltd.	Cox & Kings (India) Ltd.
Tata Sponge Iron Ltd.	Electrosteel Castings Ltd.
	Kwality Ltd.
	MMP Industries Ltd.

Category returns	Absolute Monthly Returns %	
	Oct-18	Sep-18
Large Cap Funds	-3.81	-7.69
Large Cap and midcap Funds	-2.39	-9.48
Multicap Equity	-2.97	-8.95
Focused	-3.33	-9.27
Value-Contra	-2.78	-8.61
Mid Cap	-1.51	-11.35
Small Cap	-1.83	-12.11
Arbitrage funds	0.64	0.73
Infrastructure	-2.10	-11.29
ELSS	-3.26	-9.17
Index	-4.88	-6.35
Aggressive Hybrid	-2.25	-5.92
Conservative Hybrid	-0.23	-2.66
Gilt	1.20	0.25
Dynamic	0.78	0.10
Medium to Long	0.86	-0.06
Medium	0.62	-0.24
Short duration	0.49	-0.09
Corporate	0.70	-0.27
BPSU	0.69	0.03
Credit Risk	0.12	-0.52
Low Duration	0.66	0.22
Money Market	0.23	0.35
Ultra short duration funds	0.67	-0.12
Liquid	0.62	0.21

Category returns represented by average of CRISIL ranked funds - September 2018

- Indian equity indices lost around 5% in October owing to disappointing domestic and global cues.
- Persistent weakness of the rupee against the dollar, pullback in some index heavyweights amid earnings announcements and selling by foreign institutional investors (FIIs) pulled down the local indices.
- Domestic equities also mirrored a sell-off in global equities which fell on discouraging US corporate earnings, spike in the US bond yields and weak US economic cues.
- Further losses were, however, capped owing to sporadic recovery in the rupee and dip in crude oil prices. The market also cheered the Reserve Bank of India's (RBI) announcement of injecting Rs 40,000 crore in the banking system in November 2018 and earnings-related developments.
- Most of the Nifty indices analysed ended lower in October 2018. Nifty Energy Index and Nifty Auto were among the key losers, down 12% and 8% in the month.

### Mutual fund AUM and net flows trend



- The mutual fund industry's assets under management (AUM) increased in October driven by inflows into equity, liquid, and balanced funds. As a result, the industry's asset base expanded by Rs 19,137 crore, or 0.87%, to Rs 22.24 lakh crore in October from Rs 22.04 lakh crore in September.
- Investor interest in equities was persistent, with October witnessing inflows worth Rs 14,783 crore (the highest monthly inflows since February 2018) compared with inflows of Rs 11,251 crore in September. October marked the 31st consecutive month of inflows for the category. Weighed by mark-to-market (MTM) losses, however, equity funds' AUM declined by Rs 3,063 crore, or 0.38%, to Rs 7.99 lakh crore in October.
- Inflows persisted in balanced funds for the 53rd straight month, amounting to Rs 519 crore compared with Rs 731 crore in September. Despite the inflows, the category's AUM dropped 1.44%, or by Rs 2,542 crore, to Rs 1.75 lakh crore in October from Rs 1.77 lakh crore a month ago.
- Debt funds recorded outflows worth Rs 37,642 crore in October compared with outflows of Rs 32,504 crore in September. October marked the sixth consecutive month of outflows and the strongest monthly outflows recorded since December 2017, when the category witnessed outflows of Rs 60,151 crore. Impacted by the outflows, the category's AUM declined by Rs 33,937 crore, or 4.69%, to Rs 6.89 lakh crore from Rs 7.23 lakh crore in September.
- Gilt funds recorded outflows worth Rs 291 crore in October (the 12th straight month of outflows) as against Rs 968 crore in September. The category's AUM, however, declined by a lower Rs 198 crore, or 2.47%, to Rs 7,820 crore in October, marking the first time the category's asset base has dipped below the Rs 8,000 crore mark since November 2014.
- Reversing September's trend, liquid funds recorded inflows worth Rs 55,296 crore in October against outflows of Rs 2.11 lakh crore the month before. As a result of the inflows, the category's assets rose by Rs 59,658 crore, or 15.11%, to Rs 4.54 lakh crore in October from Rs 3.95 lakh crore in September.
- Among regulatory development, Sebi may review the existing regulatory framework for liquid schemes.

## Fund News

- Digital payments company MobiKwik acquired online mutual fund platform Clearfunds in an all-stock deal.
- Reliance Nippon Life Asset Management has filed draft papers for the fourth tranche of the CPSE ETF.

# CRISIL Fund Rank 1 Schemes - Equity

## Mutual Funds' Performance Report

Scheme Name	Point to Point Returns %						Inception Date	Average AUM (Rs.Crore)	Style Box	Std. Deviation (%)	Sharpe Ratio
	1 Month	3 Month	6 Month	1 Year	3 Years	Since Inception					
<b>Large Cap Equity</b>											
Axis Bluechip Fund	-5.16	-12.24	-4.37	2.78	9.75	11.03	5-Jan-10	2657.31		12.35	0.33
Canara Robeco Bluechip Equity Fund	-3.86	-9.04	-3.44	1.13	9.30	10.35	20-Aug-10	131.22		12.74	0.28
Edelweiss Large Cap Fund	-4.85	-10.63	-6.01	0.31	8.93	13.23	20-May-09	141.99		12.39	0.27
<b>Large &amp; Mid Cap</b>											
Invesco India Growth Opportunities Fund	-3.41	-8.80	-8.34	-0.92	10.79	10.66	9-Aug-07	809.85		12.63	0.40
Sundaram Large and Mid Cap Fund	-2.12	-7.71	-7.05	-0.41	11.87	10.33	27-Feb-07	420.68		11.94	0.49
<b>Multi Cap</b>											
Mirae Asset India Equity Fund	-2.74	-5.86	-2.61	-1.04	12.76	15.56	4-Apr-08	8632.72		13.27	0.52
Edelweiss Multi-Cap Fund	-3.60	-9.66	-9.61	-2.95	10.41	7.99	3-Feb-15	115.52		13.70	0.36
Canara Robeco Equity Diversified	-3.21	-8.76	-4.70	-0.31	8.81	17.87	16-Sep-03	903.80		13.43	0.24
<b>Focused</b>											
Axis Focused 25 Fund	-5.73	-13.92	-8.87	0.64	12.85	15.67	29-Jun-12	5636.67		13.51	0.53
<b>Value / Contra</b>											
Kotak India EQ Contra Fund	-4.56	-8.65	-5.14	1.03	11.42	12.52	27-Jul-05	521.50		12.46	0.45
<b>Mid Cap</b>											
Axis Midcap Fund	-2.01	-6.16	-5.95	4.66	9.97	17.07	18-Feb-11	1581.49		13.27	0.32
Invesco India Mid Cap Fund	-0.39	-5.44	-7.13	-2.92	10.33	14.18	19-Apr-07	201.83		13.85	0.35
<b>Small Cap</b>											
HDFC Small Cap Fund	-0.16	-6.51	-13.07	0.42	16.63	14.45	3-Apr-08	4749.07		14.49	0.72
<b>Infrastructure</b>											
L&T Infrastructure Fund	-3.08	-9.94	-14.34	-14.72	13.54	3.97	27-Sep-07	2036.33		15.93	0.51
Franklin Build India Fund	-3.42	-8.14	-7.16	-11.44	9.31	15.39	4-Sep-09	1183.38		14.72	0.26
<b>ELSS</b>											
Taurus Taxshield	-4.78	-9.63	-7.69	0.05	11.35	11.23	31-Mar-96	52.86		13.46	0.42
Invesco India Tax Plan	-4.64	-10.04	-7.24	-0.47	9.91	13.93	29-Dec-06	600.85		12.74	0.34
Aditya Birla Sun Life Tax Relief 96	-5.49	-9.71	-10.35	-4.05	10.76	10.55	7-Mar-08	6534.27		12.02	0.41
<b>Index</b>											
SBI - ETF SENSEX	-4.82	-8.17	-1.18	4.81	10.22	12.24	15-Mar-13	12495.90		12.37	0.36
Kotak Nifty ETF	-4.88	-8.28	-2.41	1.76	10.08	10.33	2-Feb-10	549.61		12.63	0.34

CRISIL Mutual Fund Ranks as of September 2018

Point to Point Returns are as on October 31, 2018

Returns are annualised for periods above 1-year, other wise actualised

Risk Ratios are annualised

Period for Risk Ratios is three years

For Sharpe Ratio the risk free rate is 6.50% - the average 91-day T-Bill auction cut-off rate for three years

Average AUM is 3-months average number as disclosed by AMFI for the period July-September 2018

### Style Box Legend

	Value	Blend	Growth
Large Cap	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Small & Midcap	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
Diversified	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

## Average Assets under Management - A Bird's Eye View

Mutual Fund Name	Jul-Sep 2018 (Rs.Crore)	Apr-Jun 2018 (Rs.Crore)	Change (Rs.Crore)	% Change	Mutual Fund Name	Jul-Sep 2018 (Rs.Crore)	Apr-Jun 2018 (Rs.Crore)	Change (Rs.Crore)	% Change
ICICI Prudential Mutual Fund	310681	310561	119	0.04	Baroda Pioneer Mutual Fund	13564	12240	1324	10.81
HDFC Mutual Fund	306588	307082	-495	-0.16	JM Financial Mutual Fund	12672	12073	599	4.96
Aditya Birla Sun Life Mutual Fund	254451	249507	4943	1.98	HSBC Mutual Fund	12622	11336	1286	11.34
SBI Mutual Fund	254146	233474	20672	8.85	IDBI Mutual Fund	9992	10574	-582	-5.50
Reliance Mutual Fund	245450	241096	4354	1.81	BNP Paribas Mutual Fund	8523	8060	464	5.75
UTI Mutual Fund	165946	153183	12763	8.33	Indiabulls Mutual Fund	8008	7992	16	0.19
Kotak Mahindra Mutual Fund	134583	127830	6753	5.28	PRINCIPAL Mutual Fund	7793	7418	375	5.06
Franklin Templeton Mutual Fund	111403	105403	6000	5.69	BOI AXA Mutual Fund	5872	5692	180	3.15
DSP Mutual Fund	95457	89404	6053	6.77	Union Mutual Fund	4910	4433	477	10.77
Axis Mutual Fund	87678	79252	8426	10.63	Mahindra Mutual Fund	4336	3961	375	9.47
L&T Mutual Fund	73753	71118	2634	3.70	Essel Mutual Fund	2256	1790	466	26.02
IDFC Mutual Fund	69723	69841	-118	-0.17	IL&FS Mutual Fund (IDF)	1514	1473	41	2.75
Tata Mutual Fund	54824	49221	5604	11.38	IIFL Mutual Fund	1506	1257	249	19.80
Sundaram Mutual Fund	33103	32789	314	0.96	PPFAS Mutual Fund	1376	1099	278	25.28
Invesco Mutual Fund	27568	24932	2636	10.57	Quantum Mutual Fund	1295	1261	34	2.72
DHFL Pramerica Mutual Fund	22700	23137	-437	-1.89	IIFCL Mutual Fund (IDF)	639	646	-7	-1.10
Mirae Asset Mutual Fund	20569	19178	1391	7.25	Taurus Mutual Fund	454	452	2	0.43
LIC Mutual Fund	20426	20411	14	0.07	Quant Mutual Fund	184	176	8	4.83
Motilal Oswal Mutual Fund	20305	19264	1041	5.41	Sahara Mutual Fund	58	59	-2	-3.12
Edelweiss Mutual Fund	14161	12502	1660	13.28	Shriram Mutual Fund	54	47	7	14.33
Canara Robeco Mutual Fund	14082	13375	707	5.29	<b>Grand Total</b>	<b>2435225</b>	<b>2344600</b>	<b>90625</b>	<b>3.87</b>

AAUM is the quarterly average number and excludes Fund of Funds

## Fund Focus

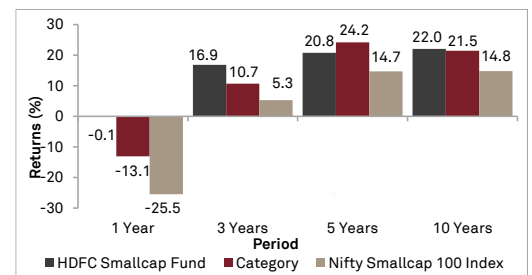
### HDFC Small Cap Fund (CRISIL Fund Rank 1)

Launched in April 2008, HDFC Small Cap Fund has been ranked in the top 10 percentile (rank 1) for the three quarters ended September 2018 under the small cap fund category of CRISIL Mutual Fund Ranking (CMFR). The fund's average assets under management (AUM) increased steadily over the past three quarters from Rs 2,577 crore at the end of March to Rs 4,749 crore at the end of September 2018.

### Investment approach

The fund's investment objective is to provide long-term capital appreciation and income by investing predominantly in small cap companies.

### Chart 1: Performance as on November 19, 2018



Note: Returns above one year are annualised

### Performance

The fund has mostly outperformed its benchmark (the Nifty Small Cap 100 index) and its peer group (represented by the small cap funds category as per CMFR - September 2018) across the time periods analysed (Chart 1). Since the scheme's commencement of operations in 2008, it has given unit holders returns of over 14% compared with the benchmark's 5%.

### Better risk-adjusted returns

The fund has outperformed its category and the benchmark on a risk-adjusted basis as measured by the Sharpe ratio (higher the better) over the three years ended November 19, 2018. The fund's Sharpe ratio is 1.06 against 0.17 and 0.57, respectively, for its benchmark and the category over this period.

### Portfolio analysis

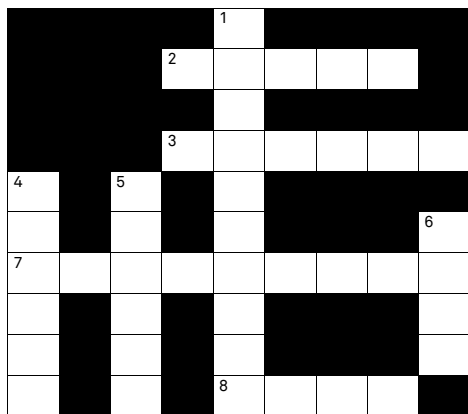
During the three years ended October 2018, the fund's equity exposure ranged from 81% to nearly 100%. In October, exposure was 85%, with the average equity holdings at 92%. To provide liquidity, the scheme has also invested in CBLOs -average 5% over the three years ended October. The scheme has consistently invested in 19 sectors over the past 36 months. Among these sectors, exposure to industrial products, banks, auto ancillaries, pharmaceuticals, and software has been the highest, and ranging from 6% to 11%. Twenty nine scrips have been held consistently over the past three years. Among the consistently held stocks, exposure to Aurobindo Pharma was the highest, averaging 3%.

### Fund manager

The scheme is managed by Chirag Setalvad, a Senior Fund Manager - Equities at the fund house having an experience of over 21 years. He holds a Bachelor's Degree in Business Administration.

Every month, Fund Focus will feature one of the CRISIL Mutual Fund Rank 1 or 2 Schemes

## Crossword Corner – boost your financial knowledge



### Horizontal

- 2) A risk management strategy which is used to limit losses (5)
- 3) A short-term debt-based scheme which has a maturity of up to 91 days (6)
- 7) A strategy to enhance returns by exploiting price differences between assets (9)
- 8) A diversified equity fund that offers tax benefits (1,1,1,1)

### Vertical

- 1) The value of this instrument changes taking cues from the price of the underlying asset that it tracks (10)
- 4) A metric used to measure the risk-adjusted returns delivered by a scheme (6)
- 5) A scheme that invests in both equity and debt instruments (6)
- 6) The benchmark interest rate at which banks can borrow from the central bank in case they experience a shortfall of funds (4)

### Answers

**Vertical:** 1) Derivative 4) Sharpe 5) Hybrid 6) Repo

**Horizontal:** 2) Hedge 3) Liquid 7) Arbitrage 8) ELSA (Equity Linked Savings Scheme)

### Contact Details

Kruti Rawal : +91 22 3342 3361; Kruti.Rawal@crisil.com  
Deepak Mittal : +91 22 3342 8031; Deepak.Mittal@crisil.com  
Vijay Krishnamurthy: +91 22 3342 8056; Vijay.Krishnamurthy@crisil.com  
Dinesh Agarwal: +91 22 3342 3440; Dinesh.Agarwal@crisil.com  
Amrita Sarkar : +91 22 3342 8405; Amrita.Sarkar@crisil.com  
Sandeep Tripathi : +91 22 3342 8047; Sandeep.Tripathi@crisil.com  
Rajnikant Tiwari: +91 22 3342 2954; Rajnikant.Tiwari@crisil.com  
Ankur Nehra: +91 124 6722 418; Ankur.Nehra@crisil.com

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