TATA CAPITAL WEALTH

Arbitrage Fund vs Liquid Fund - Which is Better?

What are Arbitrage Funds?

Arbitrage Funds are the mutual funds that generate returns from the price differential of same security in cash and derivative market and some part of the portfolio is invested in debt and money market instruments. As per SEBI classification, arbitrage funds are classified under hybrid category and are taxed as per Equity.

Why to invest in Arbitrage Funds?

Low Risk

- These funds generate returns from arbitrage opportunities in cash and future markets and hence bear low risk.
- They are often compared to debt fund due to low risk nature of the fund.

Low Volatility

- It is an added advantage that most of the funds may give negative returns or get unpredictable in a highly unstable market, whereas arbitrage fund tends to generate better return in a volatile market.

Equity Taxation

- They are taxed as equity funds as the fund invests predominantely in equities.
- Equity funds are taxed at 15% for short term (less than 1 year) and 10% for long term for more than one year, whereas w.e.f. from April 01, 2023, debt funds are taxed as per the tax slab irrespective of the holding period.

What makes Arbitrage Funds more attractive compared to Liquid Funds?

Returns:

✓ Arbitrage funds **may generate relatively better returns than liquid funds in a volatile market**, while liquid funds tend to be relatively stable and consistent when generating returns for investors.

Tax Efficiency:

✓ Though risk level of both Arbitrage and Liquid Funds is low, **equity taxation** makes Arbitrage funds more attractive than Liquid Fund. Arbitrage funds invests in equity and equity related instruments and hence, they are treated as Equity for tax purposes.

✓ Arbitrage funds are taxed at 15%* for investment period of less than one year, while capital gains above Rs. 1 Lakh on investments held for more than one year are taxed at 10%* (**Excluding Surcharge and Cess)*. Whereas Liquid funds are taxed as per tax slab irrespective of the holding period (w.e.f. April 01, 2023). **This differential in taxation makes Arbitrage funds more tax-efficient compared to Liquid funds.**

The table given below shows post-tax returns comparison between Liquid and Arbitrage Fund for an investor who is in the highest tax bracket of 30%:

	Liquid Fund	Arbitrage Fund
Returns (Assumed)	7%	7%
Tax rate if investment held for less than 1 Year	30%*	15%*
1 Year Post Tax Returns	**4.9%**	**6.0%**
Tax rate if investment held for more than 1 year	30%*	10%*
Post Tax Returns	**4.9%**	**6.3%**

Arbitrage Funds are able to generate higher post tax returns

**Excluding Surcharge and Cess*

Who should invest in Arbitrage Funds?

- Investors who want to take exposure in Equity asset class at **relatively lower risk.**
- Investors who want higher returns (compared to savings bank) on their short-term funds.
- Investors who want to **gain from a highly volatile market** can opt for these funds.
- As Arbitrage funds follow equity taxation, investors falling under high tax brackets with investment horizon of 6 months and above **may look at these funds as tax efficient investment option.**

Bottom line

While most mutual funds struggle at the time of market volatility, arbitrage funds can have the potential to generate higher returns. Arbitrage funds do not generate higher returns during stable market conditions. Investors should carefully consider the risks involved with arbitrage funds and should have minimum horizon of atleast 6-12 months before investing in these funds. Also, investing in these funds provide investors the benefit of better post-tax returns if held more than one year as these funds are taxed similar to equity funds. The tax efficiency of arbitrage funds adds to the suitability of such funds amidst the market volatility. Moreover, it is essential to keep a close track on the debt portion allocation of arbitrage fund and the credit quality.

Investors may consider investing a part of their investment portfolio in arbitrage funds to cope up with volatile market movements and generate reasonable returns. Investors should carefully consider their financial liabilities, risk appetite, time horizon before investing in arbitrage funds.

Returns of Top Performing Funds

	Absolute Returns (%)		
Scheme Name	**3 Months**	**6 Months**	**1 Year**
Edelweiss Arbitrage Fund	1.64	3.55	5.39
Kotak Equity Arbitrage Fund	1.68	3.65	5.57
Nippon India Arbitrage Fund	1.60	3.46	5.22
Tata Arbitrage Fund	1.63	3.49	5.33
Category Average	**1.54**	**3.37**	**5.06**

Returns as on 12th May 2023. YTM as on 30th April 2023. Returns are shown for growth option regular plan. Source: ICRA MFI.

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