THE SCANNER

MULTI-ACT
Built by investors for investors

Selecting 'true' hybrid funds

Debt and equity – most investors are aware of these two asset classes that are known to anchor a majority of investor portfolios. When it comes to inclusion in investment portfolios, these two asset classes serve two unique but distinct purposes. Equity investments primarily serve the purpose of providing growth and debt investments aim to reduce portfolio volatility and provide downside protection. For an investment portfolio to be robust and grow in line with investor needs, it needs to have exposure to both debt and equity. To that extent, most investors are sorted. However, the bigger question revolves around asset allocation, i.e., how much to allocate to equity and how much to allocate to debt. The thing is that if the portfolio is highly skewed towards debt investments, then it is unlikely to generate the desired returns. On the other hand, if the portfolio is predominantly focused on equity investments, then along with the potential for higher returns the portfolio also becomes high risk and more volatile. This means that as an investor, at any given point of time, you need to be able to strike the right balance between equity and debt exposure. Not an easy task! Hybrid funds can be a potent option that solves for this conundrum.

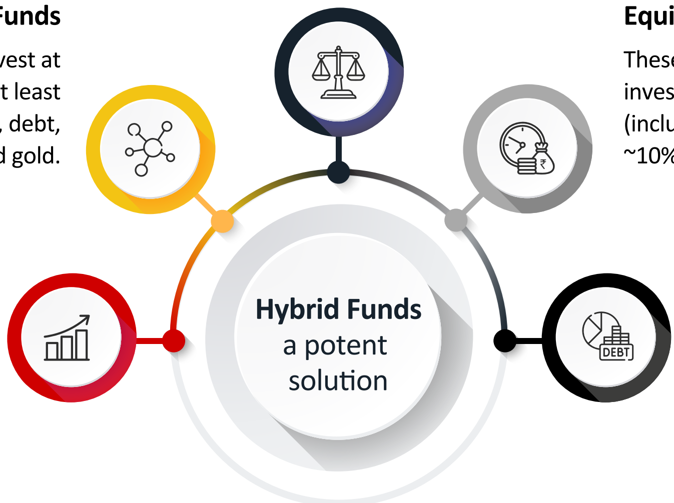
Hybrid Funds - a potent solution

Hybrid funds are those funds that invest in a mix of equity and debt instruments. They are further classified into the following categories as mandated by the Securities Exchange Board of India (SEBI).

Balanced Advantage Funds/ Dynamic Asset Allocation Funds
These funds invest in both equity and debt instruments and dynamically change allocations in response to market conditions.

Multi Asset Funds
These funds are mandated to invest at least 10% of the fund corpus in at least 3 asset classes each, i.e., equity, debt, and gold.

Equity Savings Funds
These funds are mandated to invest ~65% of the corpus in equity (including arbitrage positions) and ~10% in debt instruments.



Aggressive Hybrid Funds
These funds are mandated to invest 65-80% of the fund corpus in equity and equity related instruments and the balance 20-35% in debt instruments.

Conservative Hybrid Funds
These funds are mandated to invest 10-25% of the fund corpus in equity and equity related instruments and 75-90% of the corpus in debt instruments.

The question that you need to ask is whether hybrid funds are a worthy inclusion in your portfolio. The answer would primarily depend on your overall portfolio strategy. If you are independently and proactively investing in direct equity and debt instruments, then hybrid funds may not add much value to your portfolio. This is because you are yourself taking an active asset allocation call at a portfolio level. However, if you are not taking an asset allocation call, hybrid funds can be a useful addition to the portfolio, especially during periods of expensive market valuations and heightened volatility.

As is evident from the above infographic, not every hybrid fund will give you the kind of exposure you desire or help you to strike the required balance between debt and equity investments. Some hybrid funds are basically debt funds with a mild flavour of equity while others are simply equity funds with a small dose of debt. Further, even when you choose to invest in a particular type of hybrid fund, can you always be sure that it is true to label?

Exhibit 1: Inflows into hybrid funds

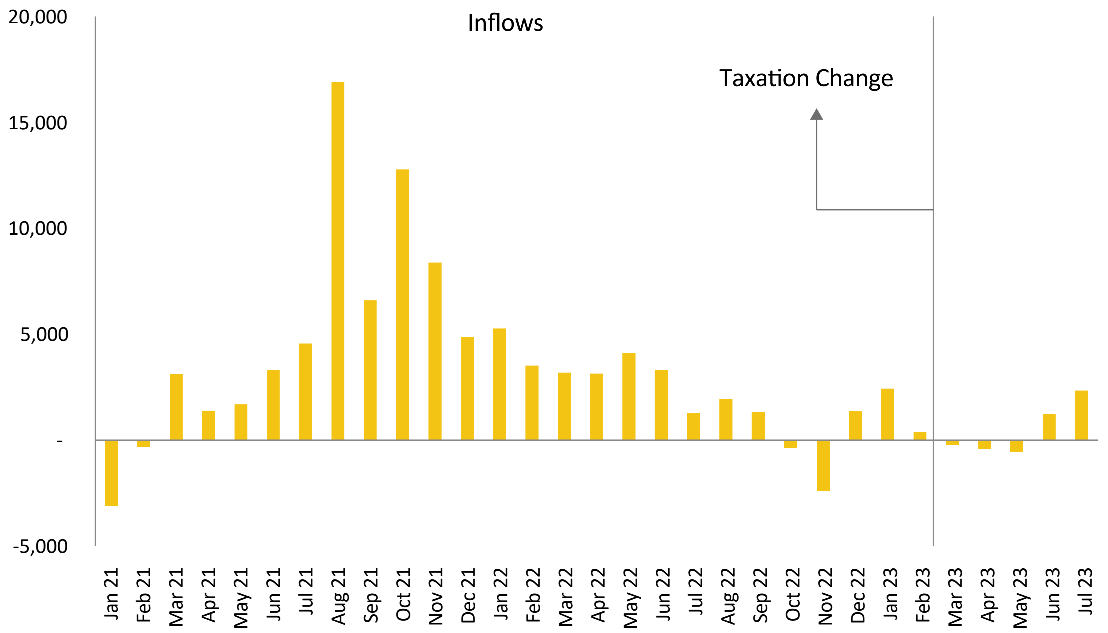
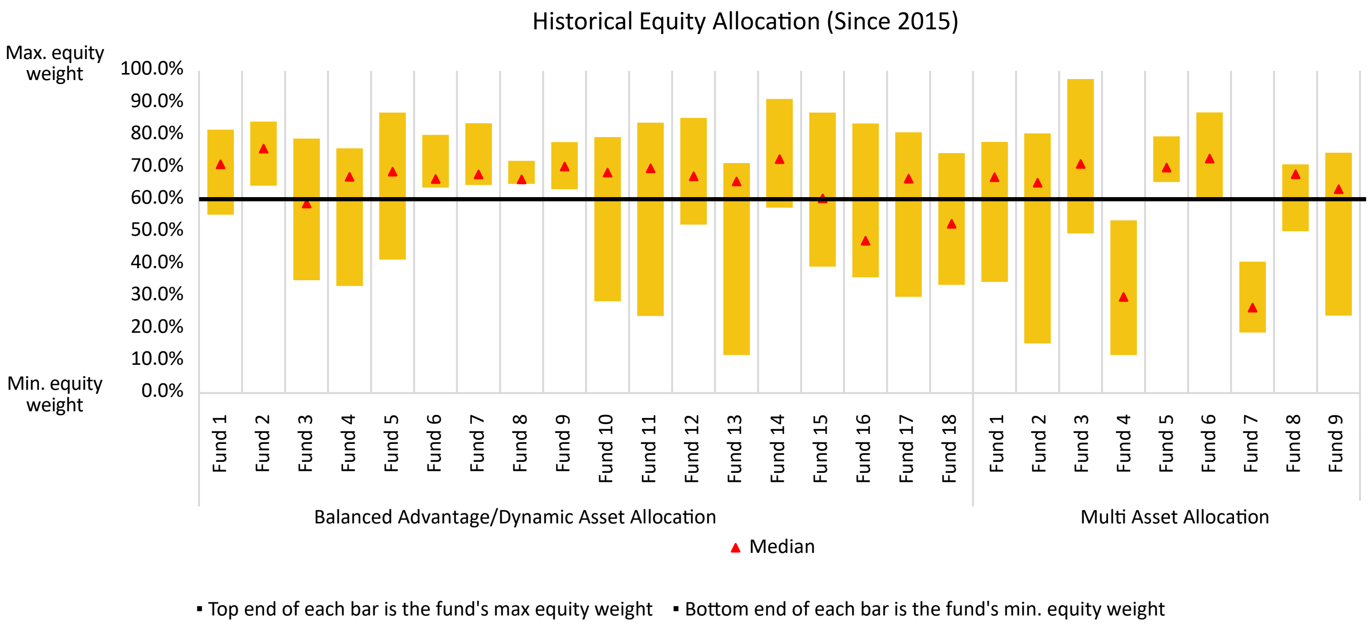


Exhibit 2: Historical equity allocation of balanced advantage funds and multi-asset funds



Q&A

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Why do you think investors are increasingly gravitating towards hybrid funds?

The current narrative propounds that the increased flows can be attributed to the changes in taxation of pure debt funds with investors opting for hybrid funds which offer beneficial tax treatment. Earlier, both pure debt funds and hybrid funds were subject to long term capital gains tax @ 20%, if held for 3 years or more, and were eligible for indexation benefit. However, from the current financial year, debt funds will be taxed at the maximum marginal rate irrespective of holding period and hybrid funds will continue to be taxed as before. Herein lies a strong tax advantage in favour of hybrid funds.

However, as data in exhibit 1 suggests that hybrid funds have witnessed higher flows in periods before the above-described taxation changes as well. Prior period inflows can be explained by many things but two major causes could be:

- Launch of 2 new schemes viz, SBI Balanced Advantage Fund in Aug 2021 and NJ Balanced Advantage Fund in Oct 2021
- High valuation of broader market has made balanced advantage funds an attractive investment option

Are you concerned that a lot of hybrid funds in the market are not true to label? Please explain.

Barring 'Balanced Advantage Funds/Dynamic Asset Allocation Funds' and 'Multi Asset Funds', other categories are restricted in terms of the minimum and maximum exposure that they can build in each asset class. Such kind of exposure can be recreated by the investor by investing in a combination of pure equity and pure debt funds, and most probably at a lower expense ratio than hybrid funds.

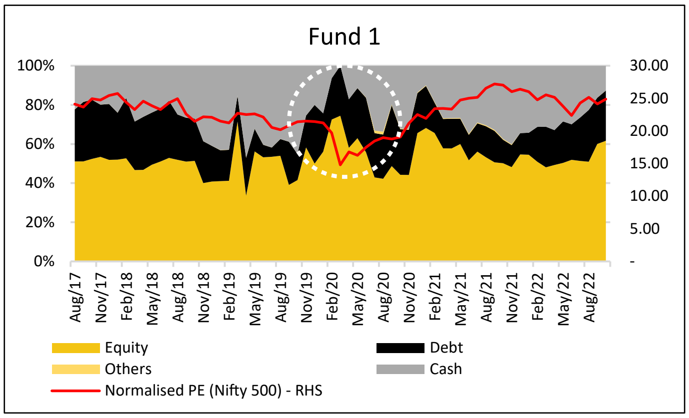
This makes 'Balanced Advantage Funds/Dynamic Asset Allocation Funds' and 'Multi Asset Funds' compelling investment options as there are no restrictions imposed on them in terms of minimum weight to different asset classes. Theoretically, schemes from these categories have the flexibility to move around different asset classes depending on market opportunities. But they seldom exercise it.

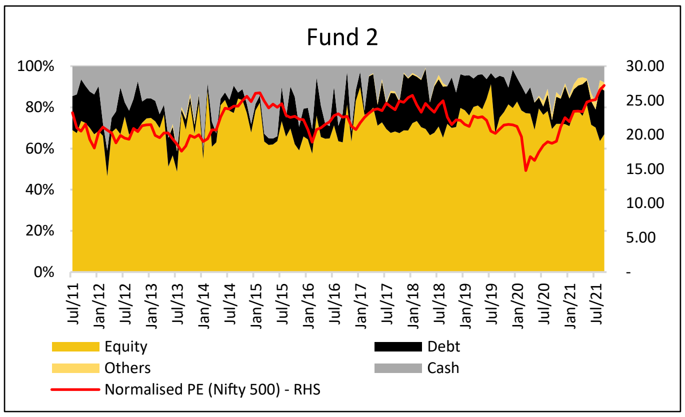
As can be observed from Exhibit 2, only a handful of schemes reduce their equity weights below standard portfolio equity weight of 60%. The categories of funds that make sense to an investor are the ones that take active asset allocation calls. However, even funds that have the flexibility to take those calls do so rarely.

Thus, it can be said that while all hybrid funds are true to the label, funds from certain categories are not exercising the flexibility provided to them. Investors should be aware of this fact while evaluating any hybrid fund.

How to identify hybrid funds that are taking active asset allocation calls?

A good approach would be to assess the historical movement of allocation to different asset classes. The first step of evaluation is to understand whether the fund is truly taking active asset allocation calls or is it simply sticking to 60%-40% weights of equity-debt. The next step is to assess if the asset allocation calls taken by the fund were effective or not. We would prefer a fund that has increased equity weights meaningfully when markets corrected (Fund 1) than the ones that make minor tweaks to weights every now and then (Fund 2).





What is your current view on hybrid funds?

Looking at the current market environment, it can be observed that based on traditional metrics like market PE, market valuations have remained at elevated levels since the second half of 2021. During periods of such stretched valuations, there is some utility in including hybrid funds in the portfolio as they offer better risk-adjusted returns and lower drawdowns than pure equity funds.

What are the parameters that investors should consider while evaluating mutual fund investments?

In addition to the elements mentioned so far (which are specific to active hybrid funds), there are a few more parameters that are worthy of analysis. These include:

- Factor impact: The market can be broken down into different segments based on factors like Quality, Valuation, Momentum, etc. In different market cycles, different factors tend to outperform / underperform. We believe that while evaluating any fund, one must identify the factor that the fund has historically represented by studying the underlying holdings of the portfolio. Once this is done, the next logical step is to create a portfolio of such funds that cater to different factors or styles so that the overall portfolio has uncorrelated funds exposure. However, it is important to highlight that since the underlying holding level analytics is done on an end-of-month basis, such an approach to analysis will be useful for funds with low portfolio churn.

- Past performance analysis: In addition to the above in-depth analysis, a review of past performance is also a must.

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