THE SCANNER

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Hybrid funds:

A heady mixture or a soothing salve?

Once upon a time, choosing between equity and debt often felt like picking sides in an endless tug-of-war between growth and safety. Into this dilemma, walked the suave and dynamic hybrid funds, dressed in a smart blazer and sneakers, equally at home in both camps. Think of them as the ultimate multi-taskers, designed for those who want to harness the upside potential of equities without having to endure the sleepless nights that equity can sometimes unleash.

In recent years, as investors seek balance amid market mood swings, hybrid funds have quietly emerged as the middle path, offering participation in equities with a built-in cushion against volatility. Whether one is a cautious first timer, easing into markets or a seasoned investor tired of volatility, these funds whisper a tempting promise: "You can have your cake and eat it too."

So, is the hybrid fund truly the sweet spot between risk and reward or just a clever compromise? Let's stir the mix and find out.

The mechanics behind the mix

Hybrid funds, as the name suggests, are a mix of two asset classes, i.e., debt and equity (with the occasional third wheel such as gold or arbitrage) in varying proportions to deliver a smoother investment experience. However, this is a somewhat oversimplification that can also be deceptive. Within this category exist multiple sub-types, each with a unique exposure to the two asset classes and commensurate risk-return profiles. Before we deep dive into the types of hybrid funds, it is important to underscore how taxation shapes their construction.

Equity fund taxation

To qualify as equity-oriented, a fund must hold at least 65% of its portfolio in equities and equity related instruments (including arbitrage). Following the Union Budget 2024, the tax structure was revised:

- Short-term capital gains (STCG) on holdings of less than one year are taxed at 20%, applicable for units sold on or after 23 July 2024(previously 15%).
- Long-term capital gains (LTCG) on holdings exceeding one year are taxed at 12.5%, applicable to gains above ₹1.25 lakh in a financial year.

For classification purposes, many hybrid funds include arbitrage positions as part of their equity exposure to meet the 65% threshold, allowing funds to maintain tax efficiency even while reducing direct equity risk. Although, this treatment may vary across schemes and fund categories.

Debt fund taxation

Debt mutual funds are taxed as per the investor's income-tax slab, with no distinction between short- and long-term holdings. The indexation benefit, which earlier reduced the tax burden for long-term holdings, was removed for new investments made after 1 April 2023 (Finance Act 2023, Government of India).

The spectrum of hybrid funds

Balanced advantage/dynamic asset allocation funds

The most flexible of the category, these funds shift between equity and debt depending on market conditions. Asset allocation models typically rely on valuation indicators such as price-to-earnings, price-to-book, or dividend yield, sometimes complemented by momentum or volatility metrics. Macroeconomic factors and market sentiment further influence allocation decisions.

While there is no restriction on weights, this category of funds may allow investors to participate in the upside, protecting the downside. For these funds to be tax efficient, they maintain a minimum allocation of 65% equity (includes arbitrage positions).

Aggressive hybrid funds

Ideal for investors who enjoy a little market adventure without diving in headfirst and have a moderate risk appetite. With approximately 65–80% of assets in equities and the rest in debt, they balance the growth potential of equities with a cushion of stability that debt provides. These funds aim to deliver superior long-term returns while softening short-term volatility — ideal for those seeking equity exposure but with a safety net that keeps sleepless nights at bay.

Balanced hybrid funds

These funds are the middle ground where equity and debt co-exist almost equally, creating a true blend of growth and safety. By maintaining a near 50-50 allocation, they offer a smoother ride through market ups and downs. Perfect for investors who prefer moderation over momentum, these funds focus on consistency, combining capital appreciation with steady income — a classic choice for those who value balance over boldness. However, it is important to note that there are only two funds available currently (as of October 2025) in the category, with both being launched only recently. Further, the equity taxation benefits are unlikely to accrue to such funds.

Conservative hybrid funds

Leaning towards safety first, these funds invest about 75–90% in debt and the rest in equities or equity-related instruments. These funds provide a steady, income-oriented approach while shielding portfolios from sharp market swings, making it ideal for cautious investors or those seeking income stability with limited market participation. Gains are added to your income and taxed at your slab rate, especially for purchases made on or after 1 April 2023. For older holdings (pre-April 2023), long-term gains (held ≥3 years) may still qualify for 20% tax with indexation in certain cases.

Solution oriented funds

Designed for specific life goals such as retirement, children's education/marriage, or long-term wealth creation, these funds carry a mandatory lock-in period. They also blend assets strategically to align with long-term objectives. Ideal for goal-based investors, these funds replace guesswork with planning, turning aspirations into actionable, time-bound strategies for financial growth through judicious allocation to both debt and equity.

Multi-asset allocation funds

By investing across three or more asset classes — typically equity, debt, and gold — these funds reduce reliance on a single asset class and thrive on diversity. This strategy cushions portfolios against volatility while capturing opportunities wherever they arise. By spreading risk intelligently, these funds embody the proverb "don't put all your eggs in one basket," making them a smart choice for well-rounded, all-weather investing. From a taxation perspective, the specific allocation to the different asset classes will determine the tax rate.

Equity savings funds

These funds offer a balanced pathway to investors seeking growth with tempered volatility. Structured with approximately one-third allocation each to equity, arbitrage, and debt instruments , they are designed to participate in equity growth, while cushioning downside risk through debt and arbitrage components. In practice, allocations can vary, typically 15–40% in direct equities, 25–40% in arbitrage, and 20–40% in debt, ensuring total equity exposure (direct plus arbitrage) stays above 65%, which allows these funds to be classified as equity-oriented for tax purposes. This combination of growth participation, downside protection, and tax efficiency makes this an appealing choice for moderate risk investors seeking stability without sacrificing the benefits of equity investing.

Arbitrage funds

These are equity-oriented mutual funds that aim to capitalise on temporary price differences between the cash (spot) and derivatives (futures) markets to generate low-risk returns. Instead of relying on market direction, fund managers buy a stock in the spot market and simultaneously sell its futures counterpart at a higher price. The profit is locked in at the time of the trade. Since both positions are fully hedged, the strategy carries low risk and remains market neutral. The returns, in-line with short-term interest rates, are not affected by overall market direction, thus making them a popular choice in volatile conditions where more opportunities arise.

Classified as equity for tax purposes, they must hold at least 65% of assets in equities and equity-related instruments. From an investor perspective, they offer a tax-efficient way to park short-to medium-term money, serving as an alternative to liquid or overnight funds.

Exhibit: AUM in Hybrid Funds (INR Crore)

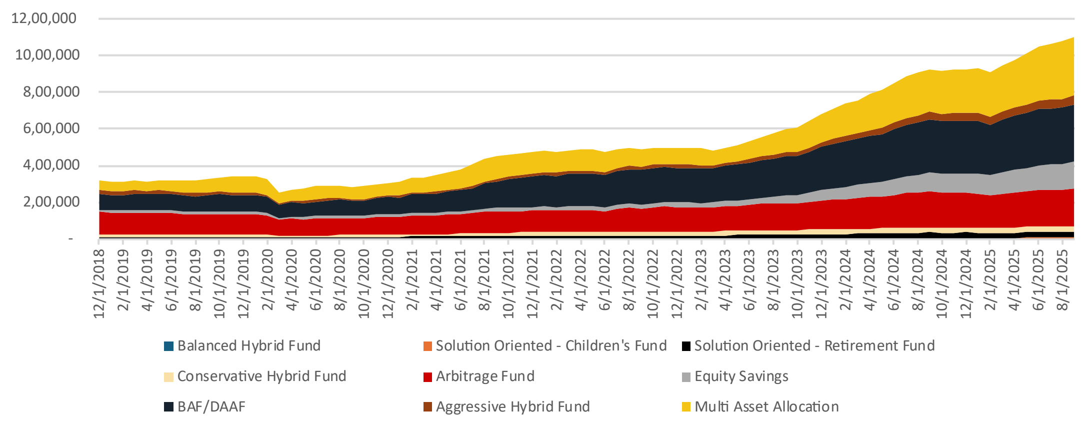
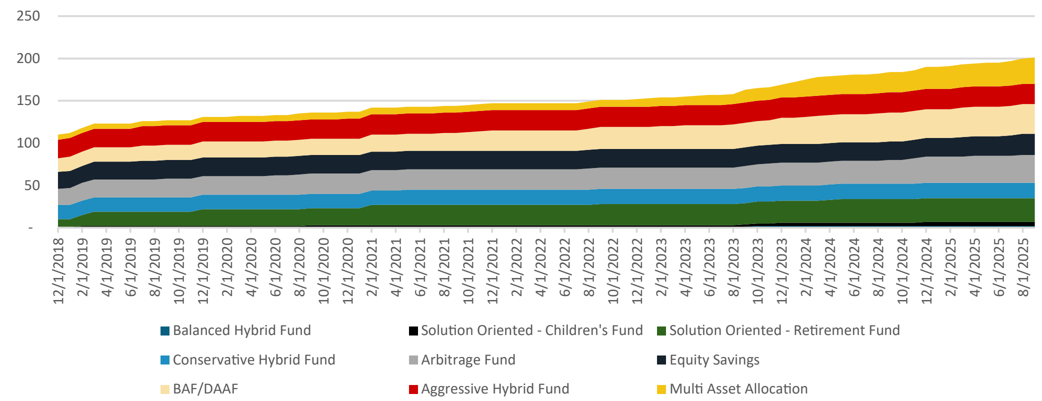


Exhibit: Count of Hybrid Funds



Q&A

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Hybrid funds have seen consistent inflows even as equity markets turned volatile. What explains this sustained appeal?

An important catalyst for flows into hybrid funds has been the removal of indexation benefits for debt funds from April 2023. For many sophisticated investors, hybrid funds have become a substitute for pure debt funds to some extent. Even though hybrid funds are mix of both equity and debt, the category allows sophisticated investors to have exposure to debt in a tax efficient manner.

Another interesting role hybrid funds play in the portfolio is that of downside protection especially when equity markets are overheated. Indian equity market has run up in recent times. Hybrid funds allow investors to participate in the market if the rally is to continue (through equity portion of the portfolio) and protect downside if markets are to correct (through debt portion of the portfolio).

Hybrid funds help investors in utilising expertise on asset allocation calls of the fund managers. Few funds determine asset allocation based on valuation models whereas some others take help of technical indicators in portfolio construction.

Rebalancing between equity and debt (and gold in case of Multi Asset Allocation Funds) is also tax efficient in mutual fund structure. If an investor is to rebalance the portfolio on the same lines outside of mutual fund structure, she will have to bear significant tax burden.

How can family offices use hybrid strategies without diluting their long-term frameworks?

For family offices, all different categories of hybrid funds may not be useful from the portfolio context. For example, 'Balanced Hybrid Fund' category has limited number of funds to judge its utility to the portfolio, if any. 'Equity Savings Fund' and select 'Dynamic Asset Allocation Fund' can provide similar exposure to 'Conservative Hybrid Fund' and that too with lower taxation. It, thus, limits the usefulness of the category to a family office. Considering long time horizons of family office portfolios and objective of wealth preservation, 'Solution Oriented Funds' also may not be most appropriate for family offices.

On the other hand, 'Arbitrage Fund' and 'Equity Savings Fund' suit for the objective of short-term parking of money.

'Balanced Advantage Fund', 'Dynamic Asset Allocation Fund' and 'Multi Asset Allocation Fund' offer dynamic and manager-driven mix of equity, debt and precious metals. Such funds could be suitable for moderate risk-oriented portfolios and/or portfolio with no gold and silver allocation.

'Aggressive Hybrid Fund' should be appropriate for above moderate risk-oriented portfolios due to fixed equity and debt exposure.

How do funds use arbitrage to generate tax efficient returns?

Uniqueness about arbitrage positions is the fact that such positions are expected to generate returns in-line with short term interest rates and hence, are proxy for debt exposure. However, for income tax purposes, the same arbitrage positions are considered as equity allocation.

Arbitrage funds generate returns by exploiting short-term price differences between the cash (spot) and futures markets for the same stock or index. They buy in the spot market and simultaneously sell in the futures market when futures prices are higher, locking in a risk-free spread. Such spreads tend to be closer to short term interest rates prevailing in the economy. At expiry, as prices converge, that spread becomes profit. Since they purchase in the spot, i.e., cash market, these positions are considered as equity allocation.

Pure-play arbitrage funds maintain at least 65% equity exposure. In the case of hybrid funds, the arbitrage positions allow funds to have debt exposure maintaining equity taxation for the fund.

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