Ideas @ Edelweiss Multi Strategy Funds – Debt & The Tax Code

July 10 marked a unprecedented change for debt mutual funds as the Finance minister Arun Jaitley in his maiden Union budget said that the holding period for long-term capital gains is now three years. The ruling was meant to close the tax arbitrage between debt funds, in particular FMPs and bank fixed deposits. We welcome the change in the tax-code because debt mutual funds had become quasi NBFCs without the requisite capital adequacy and regulatory norms. In this month's Ideas @ Edelweiss Multi Strategy Funds we discuss the fixed income alternatives for investors in this new tax regime.

For maturities less than 3 months, liquid funds will continue to dominate the landscape because of the ease of use, diversification and lack of TDS. For maturities between 3 months and 1 year, the dividend option of an arbitrage mutual fund makes sense because dividends are tax-free and capital gains are taxed at 15.45% instead of the maximum marginal rate for debt funds. One catch is that the cash-futures arbitrage market has limited scale because at the present time, the total open interest of single stock futures is 62,440 cr. We expect, the open interest to expand in the present bull market as more money comes into arb funds and more stocks are included in the FNO universe but nevertheless, the market does not have the capacity to replace the 7 lakh cr debt mutual fund industry. For maturities between 1 year and 3 years, preference shares and the cumulative plan of listed NCDs like Shriram Transport Finance could be attractive but once again they are challenged by liquidity. Other non-fixed income alternatives are commodity arbitrage.

One interesting alternative to long-duration fixed income would be to invest in a basket of high-dividend yield stocks. This is a common practice in developed markets where both growth and interest rates are lower. To test this idea, we looked at the CNX Dividend Opportunities Index and found that it outperformed CRISIL Liquid over 88% of rolling 3 year periods. Equities have volatility but with a patient holding period, a combination of dividend income and value based price appreciation make them fantastic alternative to vanilla fixed income.