Is PPFAS MF's tax efficient 'debt' fund worth a look?

The fund will use a tax-efficient structure that will see LTCG taxed at 20% with indexation

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The new year has seen the launch of several new fund offers catering to the growing interest of mutual fund investors. Parag Parikh Mutual Fund is launching a new 'debt' fund on 20 February: And its novelty: The fund will use a tax-efficient structure such that long term capital gains in it will be taxed at 20% with indexation.

The fund's new structure is aligned with an announcement in the 2023 Union budget. Finance minister Nirmala Sitharaman had then made debt mutual funds taxable at slab rate, regardless of the holding period. That was a shocker for India's mutual fund industry. Historically, debt mutual funds had enjoyed a lower rate of long term capital gains (LTCG) tax—20% with indexation if held for three years or more. However, Sitharaman defined debt mutual funds as those with equity less than 35% of assets.

According to the new tax rules, hybrid funds with equity between 35% and 65% of assets will continue to enjoy the old favourable tax rates for debt funds. They also allowed asset management companies (AMCs) like PPFAS to contemplate a new design—debt funds with 35% equity but using derivatives to bring it down further and make it truly debt-like.

Within the universe of hybrid funds, there already exist some categories that have fairly low equity exposure. First, let's take dynamic asset allocation or balanced advantage funds (BAFs) in general. These funds generally keep 65% gross exposure in equity, allowing them the benefit of equity taxation (10% LTCG after one year). Their net equity exposure (after hedging) can vary enormously from fund to fund. In the current environment, most large BAFs have brought it to the 30-50% range. However, the massive use of arbitrage in these funds creates a drag on this part of the fund's returns. Arbitrage returns mirror those of liquid funds and they tend to be lower than long- term debt.

In bullish markets, the arbitrage drag is relatively modest but, in bearish markets, arbitrage can underperform greatly compared to medium- to long-term debt. Despite having Dynamic Asset Allocation in its name, PPFAS DAAF will be different. Generally, Dynamic Asset Allocation Funds or BAFs have a lot of room to shift between equity and debt depending on the fund manager's market outlook. PPFAS DAAF will be constrained, keeping its effective equity exposure in a narrow 10-15% range.

Second, we can look at equity savings funds. Equity savings funds have a roughly one-third allocation to equity, debt and arbitrage.. An equity savings fund generally has 65% gross equity but uses derivatives to bring down the effective equity exposure to 30-35%. This category suffers from the same issue as BAFs—the drag imposed by arbitrage. Parag Parikh Mutual Fund's DAAF will be more conservative than a typical equity savings fund. Starting off with a 35% gross exposure, the scheme will generally pare it down to 10-15% of assets bringing it close to the structure of its Conservative Hybrid Fund (CHF). This is a more limited use of arbitrage in the scheme than a typical BAF or equity savings fund. BAFs also tend to have a large expense ratio, however according to persons with knowledge of the matter who declined to be named, the PPFAS DAAF may have a direct plan expense ratio of just 0.3% and regular plan expense ratio of 0.6%.

A number of other fund houses also have products that keep gross equity between 35% and 65%. But these fund houses such as White Oak, DSP and SBI take exposure to multiple assets including gold (these are categorized as multi-asset funds). Many of them also take exposure to international equity (categorised as debt for tax purposes). Hence they are structurally different from the PPFAS DAAF which will be for all practical purposes a debt mutual fund.

Debt funds are generally used by investors who have a low risk appetite or who want more or less predictable returns. The DAAF will have a portfolio similar to PPFAS CHF, largely invested in state government bonds (called SDLs) or PSU debt. The 10-15% equity exposure will be in mature companies will stable cash flows such as utilities.

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How PPFAS CHF has done

Parag Parikh CHF was launched in May 2021 with a similar design. It would invest 10-15% of assets in the stocks of mature high dividend yielding companies, another 5-10% of assets in REITs (Real estate investment trusts) and InVITs and the balance 75%-80% of assets in debt, mostly state government bonds. However, it benefited hugely from the PSU rally in India over the past year that has lifted returns.

The PSU index has doubled in the past year and hence PPFAS CHF has a 1-year return of 16.8% and a return since inception of 10.6% (as of 14 Feb 2023). This may not be replicated going forward and this was not the expectation of investors when the fund was launched. However with an average yield of 7.6% on its bonds, returns in the long term may sit in the 7-9% range depending on how interest rates move.

The PPFAS DAAF is likely to give a similar return to the PPFAS CHF with two caveats. First, it will not have any REITs or InVITs. In the past 1-2 years REITs and InVITs have been flat and not added greatly to PPFAS CHF's return. However, this may change when interest rates drop. This benefit will not accrue to the new PPFAS DAAF. Second, about 15% of the scheme will be in arbitrage (hedging via derivatives). Arbitrage returns tend to mirror the return of liquid funds and hence tend to be a little lower than long-term debt returns. This can create a drag on the fund compared to PPFAS CHF, but this will be contained to just 15% of its assets. Even with these modifications, the fund is positioned well to compete in the debt mutual fund space.

What should you do?

Financial advisors have taken a positive view of the offering. "The structure of funds like PPFAS DAAF is better than funds that are structured merely for tax advantage such as hybrid funds with 65% equity and encourages you to think of exit after 1 year even though the dominant asset class in it, equity, is not designed for a one-year investment horizon. The 3- year plus time horizon that this type of fund will instil is healthier, though equity is ideally structured more as a seven- to 10-year investment horizon asset class," said Vishal Dhawan, founder, Plan Ahead Investment Advisors.

Note that you should be prepared to stay invested for more than three years in order to reap the tax benefits of this fund. Investors in the existing PPFAS CHF may also see their scheme being merged with the PPFAS DAAF—at its December 2023 annual unit holders' meeting, PPFAS AMC did not rule out such a merger.

The ins and outs of PPFAS DAAF

This new offering from PPFAS AMC will embrace a tax efficient 'debt' fund structure

Points to note
- Debt funds are taxable at slab rate
- Funds with equity 35%-65% get lower taxation after 3 years
- Some multi asset funds have embraced this structure
- PPFAS DAAF to take this route

Gross vs net equity per fund category

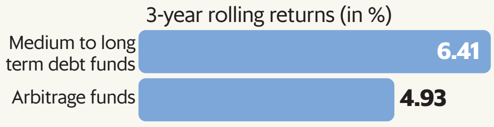
	Gross	Unhedged*
BAF/DAAFs	65%+	30-55%
Equity Savings Funds	65%+	17-36%**
PPFAS DAAF (Proposed)	35%+	10-15%

Other funds with 35-65 model

	Gross equity	Unhedged equity
SBI Multi Asset	42.15%	42.15%
Whiteoak Multi Asset	37.07%	28.25%
DSP Multi-Asset	42.80%	42.80%

Advantages of PPFAS DAAF model
- Tax benefit post 3 years, builds longer outlook
- Same broad portfolio as PPFAS CHF
- Uses debt over arbitrage (less drag from arbitrage)
- Equity in mature dividend yielding stocks

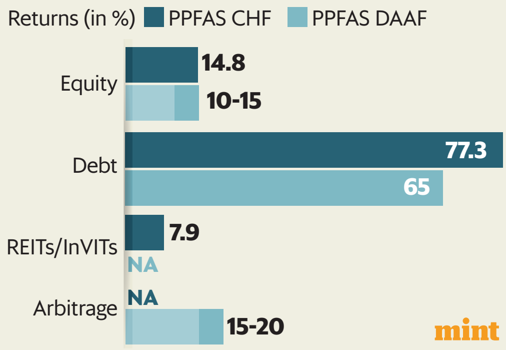
Over long periods debt returns>arbitrage returns



Potential expense ratio#

Direct plan	Regular plan
0.3%	0.6%

PPFAS CHF v PPFAS DAAF



PSU stock rallly has lifted the returns of PPFAS CHF

Launch date was 26 May 2021

PPFAS CHF returns (in %)

1 year	Since inception
16.8	10.6

SBI MF data as per Dec 2023, others as per Jan 2024 factsheet
*Analysis of ICICI, SBI, HDFC & DSP Hybrid Funds; **General range as per current allocations in large equity savings schemes. Can vary from scheme to scheme; #As per industry sources
CHF: Conservative Hybrid Fund; DAAF: Dynamic Asset Allocation Fund
Data as of 14 Feb 2023

Source: Primer Investor, MF factsheets

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