Why Hybrid Investing Matters

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From an investment perspective, these are interesting times. The Indian equity benchmark indices have registered new highs, while many fixed income options offer attractive coupons and yields. Gold prices too have rallied significantly over the past couple of years and are now at record levels. Amidst all these developments, as an investor, it is imperative to not get swayed by the wave of positivity playing out in India. This is because it is too early to write-off the potential implications of geo-political developments, global central bank policies and several other factors at play.

Disparate domestic and global economies

India is expected to be one of the top-performing economy in the world with GDP growth estimated to be more than 6% in FY24 by almost all domestic and overseas agencies. Key metrics such as PMI (Purchasing Managers' Index – services and manufacturing), IIP (Index of Industrial Production), air traffic, hotel occupancies, four-wheeler sales and credit growth are strong. Banks are in the best of health after nearly a decade grappling with of non-performing assets. Inflation (CPI and WPI) is slowly back in control and is within RBI's tolerance band.

A Rs 10 lakh crore budgetary allocation to infrastructure, incentives such as the PLI for manufacturers and the special focus on localization of defence purchase are all positives.

But advanced economies and even China are slowing down considerably. The US Federal Reserve has increased interest rates by 500 basis points since March 2022 to combat record inflation after the post-COVID stimulus measures. There have been several bank failures as well due to the travails in their treasury operations. The Euro Zone as well as the UK are staring at anaemic growth or a recession in 2023-24.

The nearly decade-long period of near-zero interest rates in most western economies and easy money is well behind us. Hence, there could be a possibility of a potential slowdown in capital flows from overseas into the equity going forward. These factors could affect start-up financing and is already leading to a funding winter for many start-ups, including unicorns in India.

Exports may be hit. Sectors dependent on overseas markets such as software are faced with reduction in discretionary spending from clients and tighter budgets. Thus, there may less chance of a one-way upward rally for the foreseeable future.

Another aspect to note would be that many states are heading for elections in December this year and the general elections are due in April-May 2024. The verdicts from these elections could also lead to volatility in equity market.

So, how does a retail investor navigate the markets in light of the discordant notes between domestic growth and a slowing global economy? This is where hybrid strategies come into play.

Hybrid funds – those that invest in a mix of stocks, bonds, arbitrage opportunities, commodities (gold, silver), REITs, InvITs – play a great role in catering to investors of all hues.

In all market conditions, more so in volatile times such as the present period, these funds make a great case for investment.

Hybrid funds for all investor temperaments

At the heart of investing in hybrid funds are two fundamentally important factors – portfolio diversification and asset allocation.

A single fund can give you access to multiple asset classes. As mentioned earlier, you get access to stocks, bonds, commodities, REITs, InvITs etc. via these funds. Investing in a diversified portfolio with multiple asset classes whose movements are independent of each other will mean lower volatility and better risk-adjusted returns over the long term.

Given below are some of the advantages of investing in hybrid funds:

***Many categories for all risk appetites*:** There are as many as six categories of hybrid funds with varying proportions of equity, debt and other asset classes. Therefore, these funds cater to investors of different risk appetites – conservative, aggressive and moderate – by altering the proportion of equity in the schemes.

***Rule-based allocation by fund manager*:** Depending on the category of hybrid fund chosen, the fund manager shuffles among equity and debt depending on the market conditions. Usually, the allocation is based on the equity valuation multiples such as price to earnings or price to book. In certain categories, fund houses are known to use in-house models to decide on the extent of equity allocation. At times when the valuation metrics are in expensive zone, the portfolio is rebalanced to include more debt and reduce equity. Thus, there is risk management at various market levels.

Makes market entry and exit decision simpler: Very often, investors wonder if they should be investing money at the prevalent index level. As fund managers make the valuation call and decide the asset allocation, investors can confidently park their money irrespective of market conditions as proportion of equity and debt as also other assets in the fund is altered to suit the evolving conditions in the market. It also allows to have an automatic asset allocation pattern without the investor having to decide the asset mix.

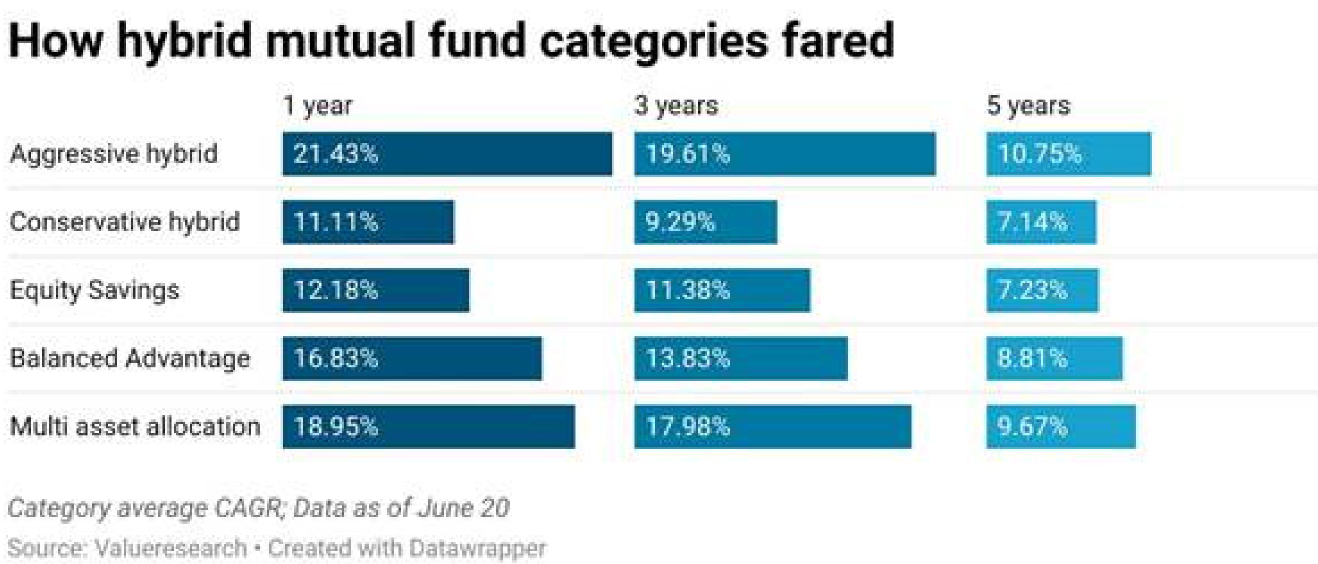
Suitable for lump-sum investments: Since allocations across equity and debt is taken by the fund manager based on a variety of valuation and other factors, lump-sum investment can be made in hybrid funds without having to worry about allocation or rebalancing. Besides, for those with uneven cash flows and the inability to commit to regular SIPs, lump-sums in hybrid funds can be considered without worrying much about risk factors.

For regular income streams after retirement: It is quite obvious that some allocation to equity is necessary even after retirement so that inflation is beaten convincingly. By parking a part of their surplus lump-sum in a category like the balanced advantage or multi-asset fund, retirees can consider systematic withdrawal plans (SWPs) to create a steady cash flow, while allowing the remaining past of their corpus to grow over the long term.

Helps in downside containment: Because hybrid funds have a mix of assets, they tend to fall less when any one particular asset class corrects, especially equities, and hence insulates the portfolio from any serious value erosion.

Choosing from distinct categories

There are five predominant categories of hybrid funds – conservative, aggressive, equity savings, balanced advantage/ dynamic asset allocation and multi-asset allocation. These suit investors with varied risk appetites. Market regulator SEBI has specified the allocation pattern for each of these categories. But given that there are no rigid mandates on the approach taken for equities or bonds, there is considerable flexibility for fund managers to take an informed call.



Conservative hybrid: These funds are allowed to invest 10-25% of their portfolio in equity and the remaining 75-90% in bonds and other debt instruments. These funds suit investors with very low risk appetite who largely prefer debt, but want a bit of equity exposure as a kicker to returns. These funds face debt taxation. All gains are added to an investor's income and taxed at the applicable slab.

Aggressive hybrid: This category of hybrid funds are schemes investing at least 65% of the portfolio in equities. The equity allocation has the flexibility to go as high as 80% here. The remaining 20-35% is expected to be invested in bonds and other fixed-income securities.

As the name suggests, the category is suitable for investors with a relatively higher risk appetite, with a desire for a majority equity exposure, but with some safety of debt as well.

An advantage with these funds is that they enjoy equity taxation. So, gains on units held for more than one year are treated as long-term capital gains and any profit in excess of Rs 1 lakh in a financial year is taxed at 10%.

Balanced advantage: These funds have dynamic asset allocation. So, 0-100% of the portfolio can be in equity or 0-100% may be invested in debt depending on the market conditions. To decide on the allocation, ICICI Prudential uses an in-house model. For example: When the Sensex fell sharply in March 2020, in the immediate aftermath of the pandemic, the ICICI Prudential Balanced Advantage Fund increased net equity in the portfolio to 73.7%. By November

2021, when markets had rallied to a well over 60,000 levels, the fund brought down its net equity to a little over 30%. As of May 2023, the net equity level stands at 39.7%. Given this approach, the fund was able to buy low and sell high and also aided investors to book profits during expensive markets, thereby protecting the portfolio from subsequent market downturns.

This category is suitable for investors with a moderate risk appetite who seek a tempered mix of equity and debt. Fund managers will use derivatives to hedge risks of equity exposure. If the blend of stocks and derivatives adds up to 65% or more, investors get to enjoy equity taxation.

***Multi-asset allocation*:** This is a versatile fund category given the all-in-one approach. Such funds give an excellent mix of equity, debt, gold/silver, REITs, InvITs etc., all within a single fund. Equity provides long-term capital appreciation while debt act as diversifier and providers stable income and adds safety to the portfolio. Gold acts as an inflation hedge and also gives diversification benefits.

As stocks, bonds and gold prices have very little correlation with each other and move due to different dynamics, a healthy mix of these asset classes provides diversification and reasonably robust returns over the long term. There is also a good chance of participating in the rally of different asset classes at different points in time.

Depending on the allocation to equity, the taxation is decided. If the allocation to stocks and derivatives collectively is 35% or higher, but lower than 65%, gains made after three years of holding would be taxed at 20% with indexation benefit.

For investors looking to broad asset allocation via a single fund, this category would be useful.

***Equity savings*:** These funds invest in equity and related instruments to the tune of 65% and debt to the extent of 10%. But in the equity portion, most of the funds in the category use derivatives for accrual income as well as for hedging purposes. Within the equity segment, funds look for arbitrage opportunities. Another strategy deployed is to execute covered calls.

These funds seek to generate better-than debt, but less than equity returns for investors. Those with a very low risk appetite would find such schemes suitable. The advantage with equity savings funds is that that enjoy equity taxation.

Final Word

While India remains a robust structural growth story, due to global macros, monetary policy decisions and geopolitical environment there could be some challenges along the way. Therefore, intermittent volatility should not be ruled out. At such times, since hybrid funds invest in two or more asset classes, investor outcomes could be more favourable by adhering to a multi-asset approach rather than investing in a single asset class at this point in time.

On the whole, with hybrid funds, investors can generate optimal returns by tempering risks and containing downsides. Over a complete market cycle, for a patient investor, the investment experience can be very encouraging.