What are balanced advantage funds?

Balanced advantage meaning a type of hybrid mutual funds which invest in equity and fixed income asset classes. The asset allocation (i.e. mix of equity and fixed income in the portfolio) of balanced advantage funds changes dynamically according to market conditions. The asset allocation of a balanced advantage is determined by the dynamic asset allocation model of the fund.

We will discuss the dynamic asset allocation model in details in the section, **How Balanced Advantage Funds work?**

What is balanced advantage fund asset allocation?

- **Net or Active Equity:** This is the un-hedged equity exposure of the fund. Net equity allocation is determined by a quantitative dynamic asset allocation model based on market conditions.
- **Fixed Income:** Fixed income allocation is determined by the asset allocation model but is usually capped at 35% to ensure equity taxation.
- **Hedging:** A part of the equity exposure of the fund is hedged using derivatives (futures and options). For example if a Balanced Advantage Fund has Stock "A" in its portfolio, then it will short (sell) futures of the stock " A" in the derivatives market for hedging. If the share price of stock "A" falls, the net asset value (NAV) of the scheme will go down, but the scheme perhaps make a profit on the futures position – the net impact on NAV will be zero. On the other hand, if the price of stock "A" rises, the NAV will go up, but the scheme will perhaps make a loss on the futures position – the net impact on NAV will again be zero. Hedged equity component will not have market risks. Hedging reduces the net equity exposure (overall portfolio risk) and at the same time, helps to keep the gross equity exposure above 65%, which enables equity taxation.

How does balanced advantage funds work?

- Balanced advantage funds use quantitative dynamic asset allocation models to change their asset allocation depending on market conditions. Most balanced advantage funds use counter-cyclical dynamic asset allocation models.
- Counter-cyclical dynamic asset allocation models decrease equity allocation and increase fixed income and / or hedging allocation if equity valuations are high. If equity valuations are low, then the model increases equity allocation and decreases fixed income and / or hedging allocation. In counter-cyclical dynamic asset allocation models you are essentially "buying low and selling high".
- Different balanced advantage funds use different valuation metrics for dynamic asset allocation, the most common being P/E and P/B ratios. Some fund managers use multi-factor models which combine 2 or more factors e.g. P/E, P/B and Dividend Yield etc.
- Some balanced advantage funds may use pro-cyclical dynamic asset allocation models. Pro-cyclical models aim to capture the upside during the bull market and protect downside in bear markets. Funds employing pro-cyclical models increase their equity allocation in rising markets and reduce it in falling markets.
- Some balanced advantage funds may use a combination of both counter-cyclical and pro-cyclical approaches. The core asset allocation of these schemes follow the counter-cyclical method, while the tactically using market trend / momentum based strategies (pro-cyclical) to maximize upside potential and limit downside risk

How balanced advantage funds work to generate returns?

- The net equity exposure (un-hedged equity) may generate capital appreciation over long investment horizons. Historical data shows that equity as an asset class can generate superior inflation adjusted returns over long investment horizons; Nifty 50 TRI gave 14.52% CAGR returns over the last 10 years ending 31st May 2022 (source: National Stock Exchange).
- The fixed income part of the portfolio generates income and provides stability to the portfolio. Different balanced advantage funds may have different fixed income strategies – most schemes use accrual based investment strategies to reduce interest rate risk, but some schemes may take duration calls depending on the interest rate scenario.

- Some balanced advantage funds may generate arbitrage profits in its hedged positions. Schemes may make arbitrage profits (risk free profits) by exploiting price differences in the differences in cash and derivatives (F&O) market. For example if Stock "A" is trading at Rs 100 in the cash market and futures of Stock "A" is trading at Rs 102 in the F&O market, then the fund manager can lock-in Rs 2 of arbitrage profits by simultaneously buying Stock "A" in the cash market and selling futures of Stock "A" in the F&O market. This profit is locked-in irrespective of whether the share price goes up or down.
- In September 2021, SEBI introduced covered calls facility for mutual funds. This provision will allow mutual funds to earn extra income by writing (selling) call options for the stocks held by the scheme in the mutual fund's portfolio.

Balanced Advantage Fund Benefits

- The age old investing wisdom is buying low and selling high. However, behavioural biases affect investment decisions. Instead of "buying low and selling high" investors usually buy when market is high, thinking it will go higher. Similarly, investors sell when market is low, thinking it will fall even lower. By using a model based approach, balanced advantage funds eliminate behavioural biases in investing.
- These funds can be less volatile than aggressive hybrid funds because they tend to have lower equity allocations at market peaks. Consequently in corrections they may have lesser drawdowns.
- Since Balanced Advantage Funds can be relatively less volatile compared to equity funds and aggressive hybrid funds, they can suitable for new investors who have not experienced market volatility. This can be one of the main **investment Benefits of Balanced Advantage Funds**
- Balanced Advantage Funds reduce equity allocation when valuations are high and increase it when valuations are low, generating potential risk adjusted returns for investors over sufficiently long investment tenures.
- One of the **Balanced Advantage Funds advantages** is that it enjoys equity taxation if their average gross (hedged and un-hedged) equity exposure is 65% or more.

What are the risks involved in Balanced Advantage Funds?

- Though SEBI has no upper / lower asset allocation limits for balanced advantage funds, balanced advantage funds will have some equity exposures across all market conditions. The equity exposure of the scheme will be subject to market risks.
- The fixed income portion of the balanced advantage funds may be subject to interest rate risk and credit risk.

Prices of fixed income instruments have an inverse relationship with interest rates. If interest rate goes up, prices of fixed income instruments will come down and vice versa. The interest rate risk involved in Balanced Advantage Funds will depend on the duration of the fixed income component of the scheme. Longer the duration of the fixed income portfolio, higher will be the interest rate risk.

- The fixed income portion of balanced advantage will also be subject to credit risks. Credit risk refers to the risk of the issuer not making interest and / or principal payments.
- The market risk of balanced advantage funds (due to un-hedged equity exposure) can be somewhat offset by the potential income using derivatives. However, return on investment (ROI) from arbitrage or covered calls depend on market conditions.

Frequently asked questions

1. What is the difference between balanced advantage fund and hybrid equity fund?

Answer: Hybrid equity funds or aggressive hybrid funds have 65 – 80% un-hedged exposure to equity and 20 – 35% allocation to fixed income instruments (debt and money market). There are no asset allocation limits for balanced advantage funds e.g. the un-hedged equity exposure of a balanced advantage fund may be much lower than 65%. Balanced advantage funds investment risk may be lower than that of hybrid equity funds or aggressive hybrid funds.

2. What is the difference between balanced fund and balanced advantage fund?

Answer: As per SEBI, balanced funds must have 50% to equity and 50% allocation to fixed income instruments (debt and money market). There are no asset allocation limits for balanced advantage funds e.g. the un-hedged equity exposure of a balanced advantage fund can be lower than 50%. Furthermore, since balanced funds have 50% allocation to fixed income, they will be treated like debt funds from a taxation viewpoint. Balanced advantage funds usually enjoy equity taxation because they use derivatives to hedge. Equity taxation may be a major advantage for balanced advantage funds.

3. What is the difference between balanced advantage fund and dynamic asset allocation fund?

Answer: Balanced advantage fund and dynamic asset allocation fund are the same. There is no difference between the two. All balanced advantage funds use dynamic asset allocation strategy.