



## ARBITRAGE PORTFOLIO

### **Investment Objective**

To endeavour to earn attractive risk-adjusted returns on capital invested by taking advantage of spreads between the price of a stock future and the underlying stock.

### **Suitability of the Product**

The product may be considered suitable for investors with investments in relatively low risk assets who are looking for an alternative to potentially increase their returns.

### **Investment Strategy**

The cash futures arbitrage strategy can be employed when the price of the futures exceeds the price of the underlying stock. Two simultaneous transactions are undertaken: (a) Buying the underlying stock (b) Selling the futures.

The position may be held till expiry of the futures contracts. By definition, the price of the futures will equal the closing price of the stock on expiry. Thus, the price differential between the futures and the stock is realized. However, the position could even be closed earlier in case the price differential is realised before expiry or better opportunities are available in other stocks.

### **Illustration of Arbitrage Strategy**

Consider an example of a stock trading at Rs. 100 while the near-month futures is at Rs. 101. Additionally assume that the closing price of the stock on expiry is Rs. 110 (please note that the actual price does not make a material difference as the futures price will by definition be equal to the closing price of the stock). The table below provides an indication of how the cash futures arbitrage strategy will be undertaken:

(Rs.)	Stock	Futures	Difference
Initiating Arbitrage Transaction (Buy Stock - Sell Futures)	-100	101	1
Closing Arbitrage Transaction (Sell Stock - Buy / Expire Futures)	110	-110	0
<b>Total Gain / Loss</b>	<b>10</b>	<b>-9</b>	<b>1</b>

Thus, a total of Rs. 1 will be earned for every Rs. 100 investment in the stock over a one month period (currently sufficient liquidity in futures is largely limited to near month derivative contracts). However apart from the Rs. 100 investment in stock, there will also be a requirement of margins on the sale of the futures as well as other related costs. The net yield on the portfolio may be calculated as follows:

	Scenario I	Scenario II
Gross yield (per month)	1.00%	1.25%
No. of months arbitrage position is taken	12	12
<b>Gross yield (p.a.)</b>	<b>12.00%</b>	<b>15.00%</b>
Brokerage costs	1.92%	1.92%
<b>Net Yield on equity exposure (% p.a.)</b>	<b>10.08%</b>	<b>13.08%</b>
% of equity exposure in the portfolio	80%	80%
<b>Net yield on portfolio pre-fees (% p.a.)</b>	<b>8.06%</b>	<b>10.46%</b>
Management fee (% p.a.)	1.50%	1.50%
Operating costs (% p.a.)	0.50%	0.50%
<b>Net yield on portfolio (% p.a.)</b>	<b>6.06%</b>	<b>8.46%</b>

Note: (a) The brokerage cost of 1.92% p.a. is taken assuming a brokerage cost of 0.16% for a complete arbitrage leg (i.e. the purchase of stock and sale of futures and the subsequent reversal). Twelve complete arbitrage legs are assumed for a twelve-month period. (b) It is assumed that approximately 20% of the total portfolio is kept aside for margin requirements. This assumes an initial margin of 30%, of which 50% will be paid by way of stock as per exchange guidelines.

*( It is to be noted that the above illustration is based on certain assumptions. The assumptions on which the above illustration is based on may not be valid under actual conditions and have been given only to make the investor understand the mechanism of this product. Hence the returns indicated are purely illustrative in nature and should not be construed as assured/indicative returns on the portfolio. )*

### Factors Impacting Returns on the Arbitrage Product

- **Change in premium of the futures price to the stock price:** The futures premium tends to expand in bullish market conditions and contract in bearish market conditions. While spreads have historically ranged between 1.0 – 1.5% bps in bullish market conditions, spreads could contract significantly if markets turn sideways to bearish. On the other hand, there is also the potential to lock in to a higher premium if markets remain bullish.

In months where the spread between the futures and the stock price does not result in a yield that exceed the expected yields from a low risk fixed income mutual funds, the capital will be invested in the low risk fixed income mutual fund until spreads widen.

- **Impact costs:** A successful arbitrage strategy requires the execution of the buy and sale of the stock and futures at prices that ensures that the premium is locked in to. However the impact cost of buying in one market and selling in the other will result in this premium getting compressed. While trades would be done keeping in mind this impact

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cost, such costs could have an adverse impact on returns in times of high market volatility.

- **Margin Requirements:** The returns on the overall portfolio are a function of the proportion of initial capital that is invested in equity and the proportion that is kept aside for margin calculations. However, high mark-to-market margins as well as any additional / ad-hoc margins that may be imposed from time to time by the stock exchange, could require a higher proportion of the portfolio being kept aside for margins. This can potentially dampen the returns on the portfolio.
- **Taxation:** As per our understanding, gains or losses from investment in the stocks will be treated as short-term capital gains/losses. However, all gains or losses arising on the sale of the futures contract will be treated as speculative gains/losses. For investors that can classify both the stock and futures gains or losses under a single income head for taxation purposes (e.g. trading gains for an investment company), the gains on one leg can be set off against the losses on the other leg. However for investors who cannot set off speculative gains/losses against short-term gains/losses, a significant tax liability could arise in case of a unidirectional market. We would advise investors to seek taxation advice from their independent financial advisors/accountants before investments are made.

### Key Features of the Product\*

Minimum Investment	Rs. 1,00,00,000
Management Fees	1.50% p.a.
Custody, Professional Clearing Member, Accounting and other incidental Costs	0.50% p.a.

\* Subject to changes from time to time

### Risk Factors:

• Securities investments including investment in derivatives are subject to market risks and there is no assurance or guarantee that the objectives of the portfolios will be achieved • As with any securities investment, the value of the portfolio can go up or down depending on the factors and forces affecting the capital markets • Past performance of the Portfolio Manager may not be indicative of the performance in the future. • Prudential ICICI Asset Management Company is not responsible or liable for losses resulting from the operations of the portfolios • The value of the portfolios offered in this document may be affected by change in the general market conditions, factors and forces affecting capital markets in particular, level of interest rates, various market related factors and trading volumes, margin requirements and other regulatory requirements, settlement period and transfer procedures • The liquidity of the portfolio investments are inherently restricted by trading volumes in the securities in which it invests • Investors in the portfolios are not being offered any guaranteed returns • Derivatives including index options are specialised instruments that require an understanding not only of the underlying instrument but of the derivative itself. Derivatives require the maintenance of adequate controls to monitor the transactions entered into and the ability to forecast price or interest rate movement correctly. There is the possibility that a loss may be sustained by the portfolio as a result of the failure of another party (referred to as counterparty) to comply with the terms of the derivatives contract. Other risks in using derivatives include the risk of mispricing or improper valuations of derivatives and the inability of derivatives to correlate perfectly with underlying assets, rates and indices • Key features of the products may be changed from time to time.