‘SIFs seek to improve risk-adjusted returns, not just boost returns’

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Specialized investment funds (SIFs) are positioned between mutual funds and high-ticket investment products like portfolio management services (PMS) and alternative investment funds (AIFs). In an interview with *Mint*, Bhavesh Jain, president and co-head, factor investing, Edelweiss Mutual Fund, explains how SIFs differ, where they fit in an investor's portfolio and what investors should expect in terms of returns, risk and liquidity. *Edited excerpts:*

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SIFs are typically positioned between mutual funds and PMS. What gap do they fill for investors with ₹10-50 lakh?

SIF is becoming a very interesting public investment vehicle. If you look at the options available today, a retail investor can start with a mutual fund with small amounts. But if he wants to upgrade, the next available options are PMS and AIF, with minimum ticket sizes of ₹50 lakh and ₹1 crore, respectively.

Now, an investor with an investable corpus of ₹10-50 lakh cannot invest the entire amount in a PMS because the minimum investment is ₹50 lakh. That is the first gap that SIF bridges.

The second gap is flexibility. MFs are tightly regulated. In a large-cap fund, 80% has to be invested in the top 100 stocks. In a mid-cap fund, 65% has to be invested in the designated mid-cap universe. Even if we are negative on a particular stock, sector or even the broader market, at best we can take a hedge trade or a cash call. We cannot go short and earn profits when our negative view is right.

SIF changes that. It allows us to take short positions, although only up to about 20-25% of the AUM. Moving from zero to 25% is a meaningful increase in flexibility.

Another important difference is that there is no requirement to maintain fixed allocations across large-cap, mid-cap and small-cap stocks. The allocation depends on the product being managed.

Like MFs, SIFs will have multiple categories. Some products will compete with balanced advantage funds and equity savings funds, while others will compete with flexi-cap, mid-cap or small-cap funds. But the biggest advantage SIF has over a traditional MF is the freedom to use derivatives. That not only means short selling, but also using covered calls, straddles, strangles and other options strategies, many of which are not directional bets but are designed to generate regular income or exploit arbitrage opportunities.

Long-short investing is new to most retail investors. What happens if markets fall sharply?

Just because we have greater freedom to use derivatives does not mean risk automatically goes up. In fact, if you look at today's most conservative equity product, the arbitrage fund, it is almost entirely based on derivatives. Balanced advantage funds and equity savings funds also use derivatives extensively to manage volatility.

If markets fall 10%, a normal equity fund will broadly decline by around 9-11%, depending on the alpha generated. But in an SIF, if derivatives are used properly in the form of hedging or selective short exposure, volatility should be lower than in a traditional long-only MF. So SIFs should actually be better positioned to manage downside volatility.

It is also important to understand that the Securities and Exchange Board of India (Sebi) has not allowed leverage in SIFs. Leverage is the biggest source of risk. So investors should not assume that simply because derivatives are allowed, SIFs are necessarily high-risk, high-return products. If used correctly, derivatives can actually reduce risk.

SIFs also promise higher return potential. How should investors weigh the trade-off between returns and risk?

The primary objective of any long-short strategswy is to give investors a smoother experience over the long term. Instead of focusing only on headline returns, investors should start looking at risk-adjusted returns.

Take the example of the same fund manager running both a traditional MF and an SIF strategy with the same underlying portfolio. Because the SIF manager can take derivative positions, write covered calls and take selective short positions, he has additional tools to generate alpha. The underlying portfolio could be identical, but because of the extra flexibility available in an SIF, the manager should be in a position to generate slightly better alpha than the traditional mutual fund.

So investors should view SIF as a product that is designed to improve risk-adjusted returns. The absolute return may sometimes be slightly lower, but once you adjust for lower drawdowns and lower volatility, overall risk-adjusted return must be superior.

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>
> **Bhavesh Jain**
> President & co-head, factor investing, Edelweiss MF

What return expectations should investors have from SIFs, and how much downside should they be prepared for?

Each of the different SIF categories—large-cap, flexi-cap, mid-cap, small-cap, multi-asset, arbitrage, balanced advantage and income-plus-arbitrage strategies—will have a different risk-return profile.

A pure arbitrage strategy under SIF may generate returns in the range of 6-7%. At the other end, a mid-cap or small-cap long-short strategy could generate returns comparable to what investors expect from a traditional mid-cap fund.

Our first product, the Altiva Hybrid Long Short Fund, has been designed to outperform fixed-income solutions. Internally, we benchmark ourselves against arbitrage plus 2-3%. We aim to generate additional returns through special situations such as initial public offerings, open offers, mergers and demergers, as well as derivative strategies such as covered calls, straddles, and strangles. These are not necessarily directional trades, but they can improve risk-adjusted returns compared with a plain arbitrage fund or a traditional fixed-income fund.

What is the investment strategy behind your recently launched X Top 100 Long Short Fund?

The philosophy behind every SIF product we launch is simple—it should either generate higher returns with similar risk or deliver similar returns with lower risk.

The X Top 100 Long Short Fund is intended to compete with PMS offerings. It will run a concentrated portfolio of around 40-45 stocks selected from companies ranked between 101 and 750 by market capitalization. Around 90% of the portfolio will remain invested in cash equities, primarily across mid-cap, small-cap and micro-cap companies.

Although the product is called a long-short fund, derivative use will be limited. Sebi allows us to take short positions up to 25% of the portfolio, but there is no requirement that we must always remain short. In this strategy, derivatives will be used only to a limited extent. The flexibility to move freely between mid-cap, small-cap and micro-cap stocks is something we cannot do within the current mutual fund framework because of category regulations.

That flexibility allows us to compete with PMS while offering investors access through the SIF platform.

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