



WHAT ARE ARBITRAGE FUNDS?

**THE EQUITY
COMPASS**

EDITION
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Understanding how temporary price differences can create return opportunities

Imagine the same product being sold in two nearby markets.

In one market, it is available for ₹100. In the other, a buyer is willing to pay ₹105. A trader could buy the product for ₹100 and simultaneously agree to sell it for ₹105, capturing the ₹5 difference.

The opportunity does not depend on whether the product becomes more valuable tomorrow. It comes from the temporary difference between the two prices available today.

Arbitrage funds follow a similar approach. They seek to capture price differences between the cash and futures markets.



WHAT IS ARBITRAGE?

Arbitrage means taking advantage of a temporary price difference in the same asset across two related markets. The strategy usually involves buying at the lower price and simultaneously selling at the higher price.

The difference between these two prices is called the **spread**.

Because the buy and sell transactions are entered together, the outcome depends mainly on the spread rather than the future direction of the share price.



UNDERSTANDING THE TWO MARKETS

CASH MARKET:

The cash market is where shares are bought and sold at their current market price.

When an investor buys a share in the cash market, the investor becomes an owner of that share.

FUTURES MARKET:

A futures contract is an agreement to buy or sell an asset at a predetermined price on a future date.

Unlike buying a share, purchasing or selling a futures contract does not immediately provide ownership of the underlying company. It creates an obligation linked to the future price of that share.

The cash and futures prices of the same share can sometimes differ temporarily. This creates an arbitrage opportunity.



HOW DOES AN ARBITRAGE FUND WORK?

Suppose a company's share is trading at ₹1,000 in the cash market, while its futures contract is trading at ₹1,010. The fund may take two positions simultaneously:

TRANSACTION	MARKET	PRICE
Buy the share	Cash market	₹1,000
Sell its futures contract	Futures market	₹1,010

The ₹10 difference is the **spread** that the fund seeks to capture.

As the futures contract approaches its expiry date, its price and the cash-market price generally move closer together. This process is called **convergence**.

By closing both positions when the prices converge, the fund seeks to earn the original spread, after accounting for costs and expenses.

The fund does not need to predict whether the share price will rise or fall. Both positions are designed to offset each other.



WHAT IS A HEDGED POSITION?

A hedge is an investment position taken to reduce the effect of an unfavourable price movement.

In an arbitrage trade, the fund buys a share in the cash market and sells a futures contract on the same share. If the share price moves, the gain in one position is generally offset by the movement in the other.

This makes the strategy less dependent on the overall direction of the equity market.

However, hedging reduces risk; it does not eliminate every form of risk.



WHAT INFLUENCES RETURNS?

- **Availability of spreads**
Wider and more frequent differences between cash and futures prices can create better opportunities. When spreads are narrow, return potential may be lower.
- **Market activity**
Greater market activity and volatility may create more price differences. However, higher volatility does not automatically guarantee higher returns.
- **Liquidity**
Liquidity refers to how easily an investment can be bought or sold without significantly affecting its price. Adequate liquidity helps the fund enter and exit both positions efficiently.
- **Costs and expenses**
Transaction charges, market impact, and fund expenses reduce the amount ultimately earned from the spread.

When suitable arbitrage opportunities are limited, the fund may invest part of its portfolio in debt and money market instruments, subject to its investment mandate.



KEY RISKS AND LIMITATIONS

Arbitrage funds aim to limit directional equity risk, but they are not risk-free.

Profitable spreads may not always be available. | Transaction costs can reduce returns.

Low liquidity may affect trade execution. | Prices may change before both positions are completed.

Returns can vary across different market conditions. | Debt holdings may carry interest-rate and credit risk.



THE KEY TAKEAWAY

Arbitrage funds do not primarily ask, "Will the market rise or fall?"

Instead, they ask, "Is the same share priced differently in the cash and futures markets?"

By buying the share at one price and simultaneously selling its futures contract at another, the fund seeks to capture the temporary difference while limiting exposure to market direction.

The approach depends on available spreads, disciplined execution, sufficient liquidity, and careful cost management.