

Event Update Note

CAS effect on Arbitrage Funds



Arbitrage

Why has NAV volatility risen after CAS change in Arbitrage funds?

Executive summary

Why has NAV volatility risen after Closing Auction Session (CAS) changed?

Arbitrage funds are seeing sharper day-to-day NAV movements because the **cash equity market and the equity derivatives market are now using different closing-price mechanisms**, and those closes can temporarily diverge. The result is a **mark-to-market valuation effect** (often visible as a one-day NAV “jump” or “dip”), rather than a structural change in arbitrage returns or a material change in the core arbitrage strategy.

Simply, the recent volatility in arbitrage fund NAVs is primarily a **short-term outcome of differing closing price methodologies** between the cash equity market (now using CAS for eligible F&O stocks) and the equity derivatives market (closing later using VWAP). This is best viewed as a **temporary mark-to-market phenomenon** during market adaptation, rather than a permanent uplift in arbitrage returns or a fundamental change in the strategy’s risk/return profile.

What changed: the cash-market closure now comes from an auction.

For eligible F&O stocks, SEBI has introduced a Closing Auction Session (CAS) where the final closing price in the cash market is discovered via an auction at the end of the day. In simple terms:

- The exchange collects buy and sell interest during the auction window.
- It decides a single equilibrium price where the maximum possible quantity can be matched and executed.
- The stock then closes at that single auction price.

This mechanism can sometimes produce a closing price that is meaningfully different from where the stock traded shortly before the auction—particularly if there is one-sided buying or selling interest concentrated into the auction window.

Why this matters for arbitrage funds: futures still close differently (and later)

Arbitrage funds typically hold offsetting positions (e.g., **long cash equity + short equity futures**) in the same underlying stock. Their NAV is computed using **end-of-day prices** for both legs.

However, the closing method is currently **not aligned** across the two markets:

- **Cash equities** (for CAS-eligible F&O stocks) close at **the auction-determined price**.
- **Equity futures** continue trading until later in the afternoon, and their closing value is based on a **VWAP over a specified time window**.

Because the cash close and futures close are captured:

1. using **different mechanisms** (auction price vs VWAP), and
2. over **different timing windows**,

The cash and futures can show a **temporary end-of-day gap** (basis dislocation), even if the underlying economics of the arbitrage trade have not changed.

The key driver: temporary mark-to-market (MTM) effects, not “extra profit”

Arbitrage fund returns come from the **spread locked in at the time the trade is executed** (cash vs futures). That spread is generally realised over time (often fully by expiry). What CAS has introduced is a higher likelihood that, on certain days, the **reported closing prices** of cash and futures don't line up neatly.

Illustrative example (simplified):

- The stock trades around ₹100 during the day.
- In the closing auction, concentrated buying pushes the cash close to ₹103.
- The **futures close** (based on the later VWAP window) stays around ₹100.

An arbitrage fund holding the cash stock and short the futures can show a **one-day NAV uplift** because the cash leg is marked higher than the futures leg at the close. But that uplift is largely a **valuation/marketing difference** created by the closing method mismatch. As markets trade forward and prices converge, the NAV impact can reverse or normalise—because the “true” arbitrage payoff is still driven by the originally locked-in spread, not by a one-off closing print.

This is also why large one-day NAV moves can look dramatic when annualised (e.g., a single day's move extrapolated to an annual rate), even though the strategy's underlying return potential stays in its usual range. **This is where you see the recent volatility in the arbitrage funds NAV.**

Why it was most visible on Day 1: market adjustment and participation levels.

Both the stock-level and index-level behaviour on the first day of CAS highlighted the adjustment dynamics:

- Market participants were still adapting their execution and hedging processes to the new close.
- Participation in the closing auction is expected to build over time; early on, auction prices can be **more sensitive to imbalances**.
- Cash market effectively “sets” a final price via the auction, while the derivatives market continues to trade for longer, naturally increasing the chances of **temporary dislocation**.

As participation deepens and trading behaviour adjusts, these gaps are expected to reduce, though some elevated short-term NAV variability may persist during the transition phase. The expectation is that this will smoothen and normalize in 15-30 days.

What investors should expect (and how to interpret NAV moves)

1. Higher day-to-day NAV fluctuations in the near term are possible as CAS beds in.
2. One-day NAV spikes should not be interpreted as risk-free incremental return—they can reverse as cash and futures prices normalise.
3. The underlying arbitrage strategy stays the same: returns are still driven by the spread captured when positions are established, not by short-term closing-price differences.
4. From a practical perspective, investors may find outcomes more predictable over longer holding periods than very short horizons and may prefer staggering transactions during the transition period to reduce the impact of temporary valuation gap

Source – HSBC Mutual Fund, Bloomberg, Data as on 7 Aug 2026

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