

An Income Generating *Equity* Investment

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What is a Derivative?

- A derivative is a security whose price is dependent upon or derived from one or more underlying assets; for example the price of TISCO in the derivative market (futures / options) is determined by the price of the underlying TISCO shares in the cash market
- The most common underlying assets include stocks, bonds, commodities, currencies, market indices etc.
- Futures contracts, forward contracts, options and swaps are the most common type of derivatives

Development in Indian Derivative Markets

Date	Event
Jun 9, 2000	BSE launches first exchange traded index derivative contract
Jun 1, 2000	NSE commences trading in derivatives - launch of index futures
Jun 1, 2001	BSE commences trading on index options on Sensex
Jun 4, 2001	NSE introduces trading in index options (based on NIFTY)
Jul 2, 2001	NSE launches trading in options on individual securities
Jul 9, 2001	BSE introduces stock options on 31 stocks
Nov 9, 2001	NSE introduces futures on individual securities
Nov 9, 2002	BSE launches single stock futures
Sep 13, 2004	BSE launches weekly options - first in the world
Jun 1, 2007	NSE launches derivatives on NIFTY Junior and CNX 100

Source: NSE, BSE

Growth of Indian Derivative Markets

Total turnover in the derivatives market on NSE has surged to over 3 times the cash market over the last six years

Year	Total Turnover (Rs. In crores)		Percentage of Cash Segment
	Derivatives Segment	Cash Segment	
2007-08*	4,218,079	1,068,268	394.85%
2006-07	7,356,242	1,945,285	378.16%
2005-06	4,824,174	1,569,556	307.36%
2004-05	2,546,982	1,140,071	223.41%
2003-04	2,130,610	1,099,535	193.77%
2002-03	439,862	617,989	71.18%
2001-02	101,926	513,167	19.86%
2000-01	2,365	1,339,510	0.18%

Source: NSE
* Upto August 2007

Indian Derivative Markets

One of the leading market's in the world

Top 20 Derivatives Exchanges by Volume

Futures, options on futures, and options on securities, in millions of contracts

Rank	Exchange	Jan-Apr 2007	Jan-Apr 2006	% Change
1	Korea Exchange	925.41	908.21	1.9%
2	Eurex	617.98	496.89	24.37%
3	Chicago Mercantile Exchange	514.26	421.90	21.89%
4	Chicago Board of Trade	301.06	250.15	20.35%
5	Euronext.liffe*	283.25	241.55	17.27%
6	Chicago Board Options Exchange	274.01	204.94	33.71%
7	International Securities Exchange	223.78	193.03	15.93%
8	Bolsa de Mercadorias & Futuros	136.16	85.73	58.83%
9	Bolsa de Valores de Sao Paulo	120.43	87.98	36.88%
10	New York Mercantile Exchange	114.83	84.05	36.62%
11	Philadelphia Stock Exchange	108.10	81.68	32.34%
12	National Stock Exchange of India	96.51	65.39	47.59%
13	NYSE Arca Options	86.36	61.76	46.34%
14	American Stock Exchange	76.56	63.43	20.70%
15	JSE (South Africa)	60.64	25.56	137.27%
16	OMX Exchanges	49.74	47.82	4.02%
17	Mexican Derivatives Exchange	46.50	95.33	-51.22%
18	ICE Futures Exchange	43.91	22.46	95.51%
19	Taiwan Futures Exchange	34.37	39.32	-12.58%
20	Boston Options Exchange	33.47	32.35	3.45%

* Includes all five exchanges within the Euronext group.

Top 20 Derivatives Contracts by Volume

In millions of contracts*

Rank	Contract	Jan-Apr 2007	Jan-Apr 2006	% Change
1	Kospi 200 Index Options, KRX	905.48	886.86	2.10%
2	Eurodollar Futures, CME	192.29	155.04	24.03%
3	Euro-Bund Futures, Eurex	112.01	111.45	0.50%
4	E-mini S&P 500 Index Futures, CME	102.48	74.34	37.85%
5	10-Year T-Note Futures, CBOT	100.60	78.43	28.26%
6	DJ Euro Stoxx 50 Index Futures, Eurex	94.26	54.81	71.96%
7	Eurodollar Options, CME	92.35	87.77	5.22%
8	DJ Euro Stoxx 50 Index Options, Eurex	79.58	40.51	96.47%
9	1-Day Interbank Deposit Futures, BM&F	74.01	49.93	48.23%
10	3-Month Euribor Futures, Euronext.liffe	67.79	63.92	6.05%
11	Euro-Schatz Futures, Eurex	57.93	57.86	0.11%
12	Euro-Bobl Futures, Eurex	55.04	60.18	-8.55%
13	S&P 500 Index Options, CBOE	47.77	28.28	68.95%
14	Powershares QQQ ETF Options, Various exchanges**	46.52	32.84	41.66%
15	5-Year T-Note Futures, CBOT	46.15	41.27	11.83%
16	TIIE 28-Day Interbank Rate Futures, Mexder	43.73	91.32	-52.11%
17	Crude Oil Futures, NYMEX	38.67	22.92	74.08%
18	S&P CNX Nifty Index Futures, NSE	38.48	22.75	69.18%
19	3-Month Sterling Futures, Euronext.liffe	33.88	24.33	48.08%
20	iShares Russell 2000 Index ETF Options, Various exchanges	35.15	14.97	134.78%

* Excludes contracts based on individual equities

** Effective March 2007, the Nasdaq-100 Index Tracking Stock, the exchange-traded fund based on the Nasdaq 100 index, was renamed the Powershares QQQ.

‡ Traded on six U.S. equity options exchanges.

Presenting

HDFC **ARBITRAGE FUND**

(An Open-Ended Equity Fund)

What is Arbitrage?

- Arbitrage is the simultaneous purchase and sale of the same asset in two different markets in order to profit from price discrepancies between the markets
- Profitable arbitrage opportunities arise from the implied cost of carry and the mis-pricing across the spot, futures and options market
- For e.g. If futures are trading at a premium vis a vis the spot prices, by selling in the futures market and buying in cash market, a market neutral return is locked-in irrespective of the overall market movement

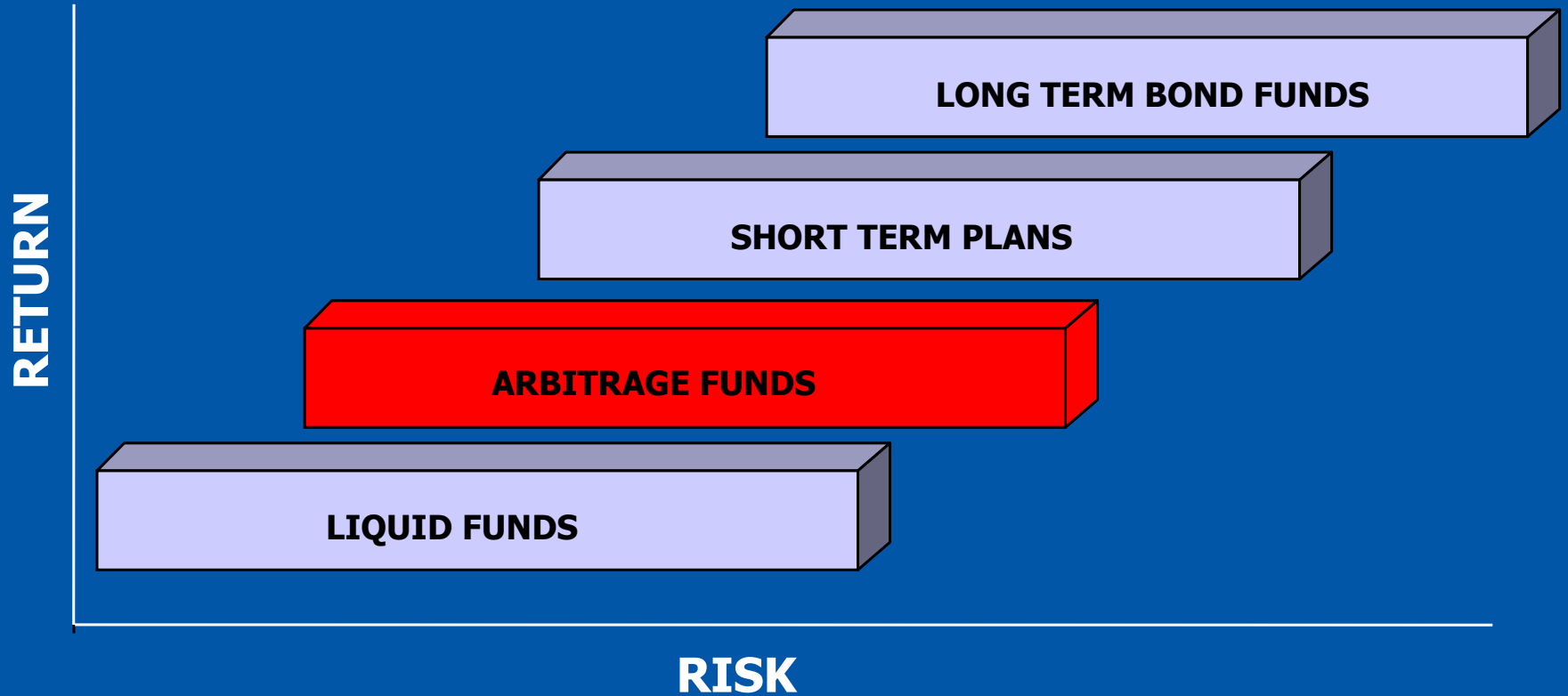
Example of Arbitrage Transaction

- On 31st July 2007:
 - Buy GMR Infra in the cash market @ 838.95
 - Sell GMR Infra 30th Aug contract in futures market @ 846.95
 - Difference: Rs. 8.00
- On expiry day, i.e. 30th August, reverse the transaction on expiry, as the **cash and the future price would converge**
- Returns = $\{8/838.95 * [365/30]\}$ = 11.60% annualized
- This is a market neutral trade as the long cash position is matched with a short futures position

Product Rationale

- Generate income through arbitrage opportunities arising out of pricing mismatch in a security between different markets or as a result of special situations
- Completely hedged positions, neutralizes market risk (volatility) and targets absolute returns irrespective of market conditions
- Enhance portfolio returns using different trading strategies within derivatives segment
- Balance of safety, returns and liquidity

Fund Positioning



Investment Strategy

- Completely hedged, take offsetting positions on various markets simultaneously
- Market neutral; no specific equity risk
- Possibility of unwinding the trade during the month and reinvestment – Chances of enhancement in returns
- All positions would be either reversed or rolled over at the expiry
- In the absence of adequate arbitrage opportunities, the scheme may invest in short term debt or money market securities
- No attempt to leverage or have short positions

Arbitrage Strategies & Opportunities

Arbitrage Strategies

■ Index / Stock Spot – Index / Stock Future

- The pricing of the futures is derived from underlying Nifty spot or the underlying stock; it is the cost of carry that binds the value of the futures to the underlying portfolio
- When the two go out of sync, there are opportunities to exploit by selling the overpriced futures and buying the underlying portfolio

■ ADR / GDR – Underlying Shares

- Depository receipts can be converted into underlying domestic shares and local shares can be reconverted into depository receipts
- If the ADR / GDR price is at a discount to the underlying share, converting the ADR / GDR into the underlying shares can result in a gain
- Intention is to capture the spread due to mis pricing in ADR / GDR and the equivalent local shares

Arbitrage Strategies

■ Dividend Arbitrage

- Around dividend declaration time, the stock futures / options market can provide a profitable opportunity
- Generally the stock price declines by the dividend amount when the stock goes ex-dividend

■ Buy Back Arbitrage

- When the company announces the buy back of its own shares, there could be opportunities due to price differential in buy back price and traded price

Trading Opportunity

(GMR Infrastructure Limited)

Date	Cash Price	Futures Price	Difference	Days	Bps	Annualised Returns
July 27, 2007	870.30	876.60	6.30	34	0.72%	7.77%
July 30, 2007	821.15	826.95	5.80	31	0.71%	8.32%
July 31, 2007	838.95	846.95	8.00	30	0.95%	11.60%
August 1, 2007	756.60	758.90	2.30	29	0.30%	3.83%
August 2, 2007	767.45	769.75	2.30	28	0.30%	3.91%
August 3, 2007	832.20	834.90	2.70	27	0.32%	4.39%
August 6, 2007	828.70	833.90	5.20	24	0.63%	9.54%
August 7, 2007	839.85	843.10	3.25	23	0.39%	6.14%
August 8, 2007	855.35	859.75	4.40	22	0.51%	8.53%
August 9, 2007	829.15	829.35	0.20	21	0.02%	0.42%
August 10, 2007	826.35	829.65	3.30	20	0.40%	7.29%
August 13, 2007	829.25	833.60	4.35	17	0.52%	11.26%
August 14, 2007	805.00	809.65	4.65	16	0.58%	13.18%
August 16, 2007	756.00	756.85	0.85	14	0.11%	2.93%
August 17, 2007	762.90	764.50	1.60	13	0.21%	5.89%
August 20, 2007	767.15	766.70	-0.45	10	-0.06%	-2.14%
August 21, 2007	726.60	726.05	-0.55	9	-0.08%	-3.07%
August 22, 2007	724.25	728.25	4.00	8	0.55%	25.20%
August 23, 2007	703.25	702.25	-1.00	7	-0.14%	-7.41%
August 24, 2007	721.80	723.20	1.40	6	0.19%	11.80%
August 27, 2007	748.35	750.40	2.05	3	0.27%	33.33%
August 28, 2007	796.90	798.75	1.85	2	0.23%	42.37%
August 29, 2007	824.40	822.65	-1.75	1	-0.21%	-77.48%
August 30, 2007	805.35	805.90	0.55	0	0.07%	

Initiate trade

Reverse trade

Re-initiate trade

Source: Bloomberg

Returns calculated by HDFC Asset Management Company Ltd

The above simulation is for illustration purpose only and does not in any manner indicate the quality of the scheme or its future prospects or returns. The AMC / Mutual Fund is not guaranteeing or forecasting returns.

Product Features, Asset Allocation Pattern and Tax Consequences

Product Features

Structure	An Open Ended Equity Fund
Investment Objective	To generate income through arbitrage opportunities between cash and derivative market and arbitrage opportunities within the derivative segment and by deployment of surplus cash in debt securities and money market instruments
Plans and Options	The scheme offers investors two plans: <ul style="list-style-type: none"> ■ Wholesale Plan ■ Retail Plan Each plan offers Growth Option and Dividend Option Dividend Option offers Monthly and Quarterly Dividend Option with payout and reinvestment facility
Application Amount (Under each option)	<ul style="list-style-type: none"> ■ Wholesale Plan: <ul style="list-style-type: none"> ■ Growth / Dividend Option: Minimum Rs. 1 crore and in multiples of Rs. 100 thereafter ■ Retail Plan: <ul style="list-style-type: none"> ■ Monthly Dividend Option: Minimum Rs. 25,000 and in multiples of Rs. 100 thereafter ■ Quarterly Dividend Option and Growth Option: Minimum Rs. 5,000 and in multiples of Rs. 100 thereafter
Duration of New Fund Offer	HDFC Arbitrage Fund will be open for initial subscription from September 28, 2007 to October 15, 2007
New Fund Offer Price	Rs. 10 per unit
Load Structure (During the New Fund Offer Period and Ongoing Basis)	Entry Load: Nil Exit Load: <ul style="list-style-type: none"> ■ In respect of each purchase / switch-in of units, an Exit load of 0.50% is payable if units are redeemed / switched-out within 3 months from the date of allotment ■ No Exit Load is payable if units are redeemed / switched-out after 3 months from the date of allotment
Liquidity	The scheme offers for sale / switch-in and Redemption / Switch-out of units on every business day on ongoing basis, commencing not later than 30 days from the closure of the New Fund Offer Period
Benchmark	CRISIL Liquid Fund Index.

Asset Allocation

Under normal circumstances the asset allocation of the Scheme's portfolio will be as follows:

Type of Instruments	Minimum Allocation (% of Net Assets)	Maximum Allocation (% of Net Assets)	Risk Profile of the Instrument
Equity and Equity related instruments	65%	90%	Medium to High
Derivatives including index futures, stock futures, index options and stock options etc. #	65%	90%	Medium to High
Debt Securities and Money market instruments* and Fixed Income Derivatives	10%	35%	Low to Medium

When adequate arbitrage opportunities are not available in the Derivative and equity markets, the asset allocation of the scheme's portfolio will be as follows:

Type of Instruments	Minimum Allocation (% of Net Assets)	Maximum Allocation (% of Net Assets)	Risk Profile of the Instrument
Equity and Equity related instruments	0%	65%	Medium to High
Derivatives including index futures, stock futures, index options and stock options etc. #	0%	65%	Medium to High
Debt Securities and Money market instruments* and Fixed Income Derivatives	35%	100%	Low to Medium

* Investments in securitised debt shall not normally exceed 50% of the net assets of the scheme

The exposure to derivatives shown in the above asset allocation table is exposure taken against the underlying equity investments and should not be considered for calculating the total asset allocation. The idea is not to take additional asset allocation with the use of derivatives. The margin money deployed on these positions would be included in the money market category

Tax Benefits / Consequences

Nature of Tax	Impact on Unit Holders
Dividend Distribution Tax	Nil. As per Sec 115R of the Income Tax Act, 1961 the scheme is not liable to pay Dividend Distribution Tax. Dividends declared, if any will be tax free in the hands of the investor
Short Term Capital Gains	As per Sec 111A of the Income Tax Act, 1961, the short term capital gains tax will be applicable @ 10% (plus applicable surcharge and education cess)
Long Term Capital Gains	As per Sec 10(38) of the Income Tax Act, 1961, any long term capital gains arising out of sale of units of this scheme will be exempt from tax
Securities Transaction Tax	As per Chapter VII of the Finance (No. 2) Act, 2004 pertaining to STT, the STT shall be payable by the seller at the rate 0.25 per cent on the sale of a unit of an equity oriented fund to the mutual fund
Tax Deduction at Source	In case of residents, no tax will be deducted at source. In case of non-residents, the provisions of Sec 195 may apply

Arbitrage Fund – Scenario Analysis

Date	Sensex Closing	Sensex Returns (%)	Arbitrage Fund Returns (%)	Liquid Fund Returns (%)
Bearish Scenario				
May 10, 2006	12612.38	-29.20	1.03	0.58
June 14, 2006	8929.44			
Bullish Scenario				
March 5, 2007	12415.04	27.22	3.73	2.94
July 24, 2007	15794.92			
Flat Scenario				
January 3, 2007	14014.92	0.87	2.98	2.45
April 24, 2007	14136.72			

Past performance may or may not be sustained in future
 Returns calculated by HDFC Asset Management Company Ltd
 All returns are absolute
 Returns for Arbitrage and Liquid Funds indicate category average returns
 Source: NAVIndia

Performance – A Comparative Analysis

(As on August 31, 2007)

Category	Returns					
	1 Month	3 Months	6 Months	9 Months	1 Year	2 Years
Debt: Medium Term	0.02	1.96	3.41	4.04	6.10	5.04
Debt: Short Term	0.31	2.26	4.44	5.55	7.39	6.47
Debt: Ultra – Short Term	0.56	1.53	3.68	5.54	7.31	6.49
Arbitrage Funds	0.81	2.50	4.87	7.42	8.89	7.93

Past performance may or may not be sustained in future
 Source: Mutual Fund Insight (September 15 – October 14, 2007)
 Returns upto one year are absolute. Returns greater than one year are annualised

Why HDFC Arbitrage Fund?

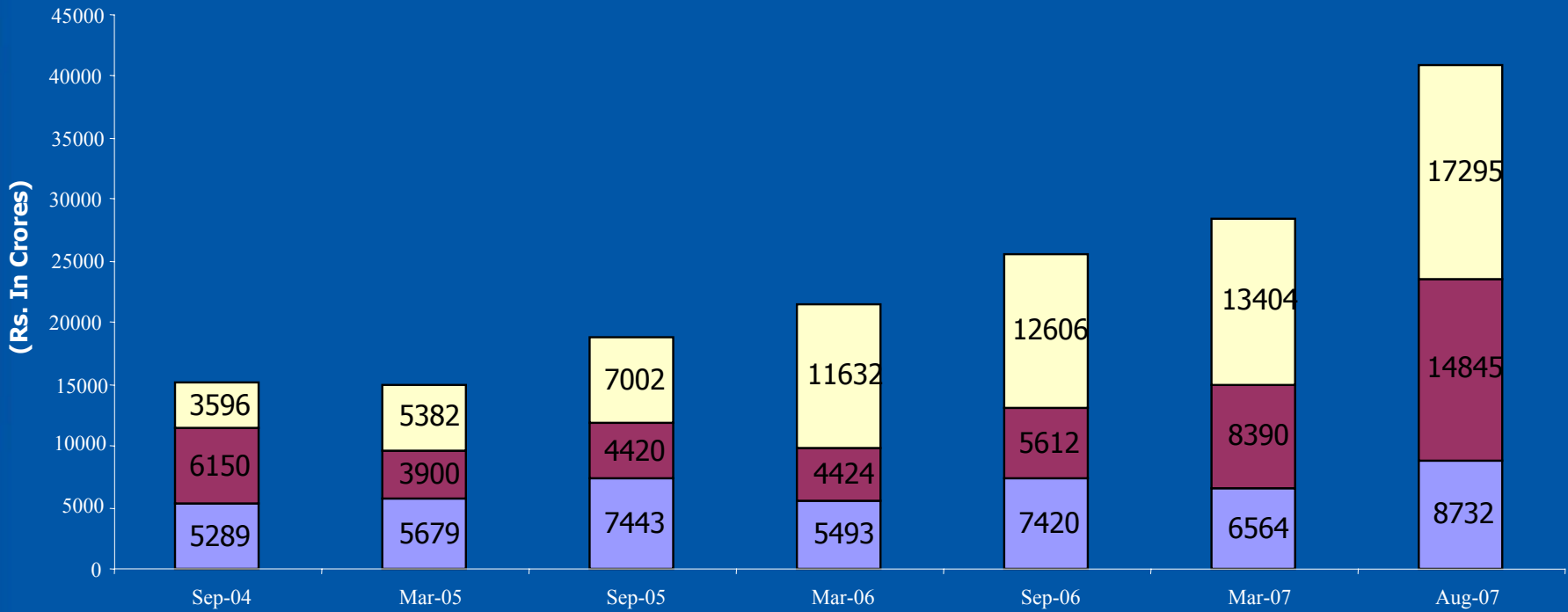
- Targets returns higher than the short term interest rates without taking the market risk
- Completely hedged positions ensure that the investors will earn the spread between the spot and future markets, indifferent to market movements
- Tax efficiency of an equity oriented scheme
- Short selling, when permitted, may present reverse arbitrage opportunity
- No entry load

HDFC Mutual Fund

An overview

Growth of Assets under Management

■ Liquid ■ Debt ■ Equity



Product offerings comprise equity, debt, hybrid and liquid funds ...

Why HDFC Mutual Fund?

- Experienced fund management and research team
- Experience of managing equity and derivatives
- Strong emphasis on managing and controlling portfolio risk
- One of the largest asset management companies in the country with Rs. 40,871 crores of assets under management (as at August 31, 2007)

CRISIL Fund House – Level 1

- CRISIL has assigned 'CRISIL Fund House Level – 1' rating to HDFC AMC
- This is its highest Fund Governance and Process Quality Rating. The rating reflects the highest governance levels and fund management practices at HDFC AMC
- HDFC AMC is the first AMC in India to have been assigned this rating
- HDFC AMC is the only fund house to have been assigned this rating for two years in succession



Glossary

Options	A financial derivative which represents a contract sold by one party (option writer) to another party (option holder). The contract offers the buyer the right, but not the obligation, to buy (call) or sell (put) a security or other financial asset at an agreed-upon price (the strike price) during a certain period of time or on a specific date (exercise date)
Open Interest	The total number of options and/or futures contracts that are not closed or delivered on a particular day
Futures	A financial contract obligating the buyer to purchase an asset (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a predetermined future date and price
Cost of carry	Costs incurred as a result of an investment position. These costs can include financial costs, such as the interest costs on bonds, interest expenses on margin accounts and interest on loans used to purchase a security, and economic costs, such as the opportunity costs associated with taking the initial position
Spread	Difference in price, when an arbitrage transaction is executed by buying and selling simultaneously in two separate markets
Rollover	Rollover means unwinding the short position in the futures of the near month and simultaneously shorting the futures of the subsequent month
Short Selling	The selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller
Hedging	Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract

- **Scheme Specific Risk Factor:** Identification and exploitation of the strategies to be pursued by the Fund Manager involve uncertainty. No assurance can be given that Fund Manager will be able to locate investment opportunities or to correctly exploit price discrepancies in the capital markets. Reduction in mis-pricing opportunities between the cash market and Future and Options market may lead to lower level of activity affecting the returns. As the Scheme proposes to execute arbitrage transactions in various markets simultaneously, this may result in high portfolio turnover and, consequently, high transaction cost. There may be instances where the price spread between cash and derivative market is insufficient to meet the cost of carry. In such situations, the fund manager due to lack of opportunities in the derivative market may not be able to outperform liquid/ money market funds.

■ **Risk Factors:** All mutual funds and securities investments are subject to market risks and there can be no assurance that the scheme's objectives will be achieved and the NAV of the Scheme may go up or down depending upon the factors and forces affecting the securities market. Past performance of the Sponsors, their affiliates / AMC / Mutual Fund, its scheme(s) do not indicate the future performance of the Scheme of the Mutual Fund. There is no assurance or guarantee to unit holders as to the rate of dividend distribution nor that dividends will be paid regularly. Investors in the Scheme are not being offered any guaranteed / assured returns. **Scheme Specific Risk Factor:** Identification and exploitation of the strategies to be pursued by the Fund Manager involve uncertainty. No assurance can be given that Fund Manager will be able to locate investment opportunities or to correctly exploit price discrepancies in the capital markets. Reduction in mis- pricing opportunities between the cash market and Future and Options market may lead to lower level of activity affecting the returns. As the Scheme proposes to execute arbitrage transactions in various markets simultaneously, this may result in high portfolio turnover and, consequently, high transaction cost. There may be instances where the price spread between cash and derivative market is insufficient to meet the cost of carry. In such situations, the fund manager due to lack of opportunities in the derivative market may not be able to outperform liquid/ money market funds. The NAV of the units issued under the Scheme may be affected, inter-alia by changes in the interest rates, trading volumes, settlement periods, transfer procedures and performance of individual securities. The NAV will inter-alia be exposed to Price / Interest Rate Risk and Credit Risk. **HDFC Arbitrage Fund**, an open-ended equity scheme is only the name of the scheme and does not in any manner indicate either the quality of the scheme, its future prospects and returns. Please read the offer document before investing. **Investment Objective:** To generate income through arbitrage opportunities between cash and derivative market and arbitrage opportunities within the derivative segment and by deployment of surplus cash in debt securities and money market instruments. **Asset Allocation Pattern:** Equity and Equity related instruments (min. 65%; max 90%), Derivative including index futures, stock futures, index options, and Stock Options etc. (min. 65%; max 90%) and Debt Securities and Money Market Securities and Fixed Income Securities (min. 10%; max 100%). Investment in securitised debt not to exceed 50% of the net assets of the Scheme. **Load Structure: Entry Load: Nil; Exit Load:** In respect of each purchase/switch-in of units, an Exit load of 0.50% is payable if units are redeemed/switched-out within 3 months from the date of allotment. No Exit Load is payable if units are redeemed/ switched-out after 3 months from the date of allotment. **Terms of Issue:** The Units are available at Rs. 10/- per unit during the New Fund Offer Period and thereafter at NAV based prices. The AMC will calculate and publish the first NAV of the Scheme not later than 30 days from the closure of the New Fund Offer Period. Subsequently, the NAVs will be calculated and disclosed at the close of every Business Day. **Statutory Details:** HDFC Mutual Fund has been set up as a trust sponsored by Housing Development Finance Corporation Limited and Standard Life Investments Limited (liability restricted to their contribution of Rs. 1 lakh each to the corpus) with HDFC Trustee Company Limited as the Trustee (Trustee under the Indian Trusts Act, 1882) and with HDFC Asset Management Company Limited ("HDFC AMC") as the Investment Manager.

■ **Disclaimer:** CRISIL Fund Governance & Process Quality Rating (FGP) reflects CRISIL's current opinion of HDFC AMC's ("the AMC") governance and process quality. The rating of CRISIL is not an opinion of the HDFC AMC's willingness or ability to make timely payments to the investor. The rating is also not an opinion on the stability of the NAVs of the funds under the management of this AMC, which could vary with market developments. A CRISIL rating is not a recommendation to buy / sell/ hold the units of various schemes of the AMC. CRISIL ratings are based on the current information provided to CRISIL by the AMC or obtained by CRISIL from sources it considers reliable.

■ CRISIL may revise, suspend or withdraw a rating as a result of new information or changes in circumstances or unavailability of information. CRISIL is not responsible for any errors in transmission and especially states that it has no financial liability whatsoever to the subscribers / users / transmitters / distributors of this rating.

■ Fund House ratings involve a detailed assessment of all aspects of an AMC's functioning: organisational structure and corporate governance; investment processes; risk management practices; operational processes, selling and client servicing practices.

Thank You