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STRATEGIC ADVISORY: THE "DOUBLE HEDGE" FRAMEWORK

Optimizing Euro-Based Allocations in USD-Denominated GIFT City Funds

To: Investment Committee / Private Client

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1. EXECUTIVE SUMMARY

For a European investor, accessing India via GIFT City (IFSC) often requires navigating a **USD-denominated ecosystem**. This creates a "Double Currency Risk":

1. **EUR to USD Entry Risk:** Exposure to the EUR/USD exchange rate.
2. **USD to INR Asset Risk:** Exposure to the structural depreciation of the Rupee.

The Solution: This report outlines a "Double Hedge" strategy. We utilize **Category III Alternative Investment Funds (AIFs)** that trade derivatives to neutralize the Rupee risk tax-efficiently, while recommending a "Synthetic Overlay" to manage the Euro-Dollar risk.

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2. THE CORE PROBLEM: "THE DOUBLE DRAG"

Most GIFT City funds are denominated in **USD**. A European investor therefore faces a two-step currency leakage.

The Mechanics of Loss (Scenario: 1-Year Holding)

- **Step 1 (Entry):** Investor converts **€1M** to **$1.16M** (Rate: 1.16).
- **Step 2 (Investment):** Fund converts **$1.16M** to **INR** to buy stocks.
- **Step 3 (Exit):**
    - *Risk A:* INR falls 4% against USD (Standard depreciation).
    - *Risk B:* Euro strengthens to 1.22 against USD (Forecast 2026).

The "Leaking Bucket" Impact:

Even if the Indian portfolio gains +15%, the currency losses (INR depreciation + Euro strength) can reduce the Net Euro Return to just +5% to +6%.

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3. THE SOLUTION: THE "DOUBLE HEDGE" STRATEGY

Phase 1: Managing the Asset Risk (USD to INR)

Objective: Ensure the fund generates a "Hard Dollar" return by neutralizing Rupee depreciation.

- **The Vehicle:** Invest *only* in **Category III AIFs** with a "Long-Short" or "Hedged" mandate.
- **The Mechanism:**
    - **Long Leg:** The Fund buys high-growth Indian stocks (e.g., Banks, Tech).
    - **Short Leg (The Hedge):** The Fund sells **INR/USD Futures** on GIFT City exchanges (NSE IX / India INX).
- **The "Derivative Alpha" (Crucial Fact):**
    - In mainland India, gains from currency derivatives are taxed at ~30-42%.
    - **In GIFT City:** Under **Section 10(4E)** of the Income Tax Act, trading gains from derivatives for Category III AIFs are generally **100% Tax-Exempt**.
    - **Result:** The fund can hedge the Rupee risk at a near-zero tax cost, preserving 3-4% more alpha than a domestic fund.

Phase 2: Managing the Entry Risk (EUR to USD)

Objective: Neutralize the risk of the Euro strengthening against the Dollar.

- **Option A (Best): The Euro Share Class**
    - *Action:* Explicitly request the **"EUR Share Class"** from the Fund House.
    - *Availability:* Many top GIFT City funds (e.g., Kotak, SBI, HDFC IBUs) have the regulatory approval to issue multiple currency classes. If they offer it, the fund takes the USD risk, not you.
- **Option B (Common): The "Synthetic Overlay"**
    - *Scenario:* If the fund is *strictly* USD-only.
    - *Action:* You invest in the USD fund, but simultaneously open a **"Short USD / Long EUR" Forward Contract** with your private bank (either in Europe or via your GIFT City IBU).
    - *Outcome:* If the Euro rises (damaging your fund's USD value), this forward contract pays out a profit that offsets the loss.
    - *Net Result:* You effectively lock in the EUR/USD exchange rate at the time of entry.

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4. SCENARIO ANALYSIS: UNHEDGED VS. DOUBLE HEDGED

Assumptions: Indian Equity Market +15%; INR depreciates 4%; EUR strengthens 5%.

Metric	Traditional (Unhedged USD Fund)	Double Hedged Strategy
Gross Equity Return	+15.0%	**+15.0%**
USD/INR Impact	-4.0% (Loss)	**0.0%** (Hedged by Fund via Derivatives)
EUR/USD Impact	-5.0% (Loss)	**0.0%** (Hedged via Forward/Class)
Cost of Hedging	0.0%	**-1.5%** (Est. Cost of Carry)
NET EURO RETURN	**+6.0%**	**+13.5%**
Alpha Captured	**40%**	**90%**

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5. OTHER VIABLE OPTIONS (FAIL-PROOF LIST)

If the "Double Hedge" is too complex, here are the only other factually viable alternatives in GIFT City:

1. **Dollar-Denominated Bonds (GIFT City):**
   - Instead of equity, invest in **USD Bonds** issued by Indian corporates (e.g., EXIM Bank, REC) listed on India INX.
   - *Why:* These pay coupons in USD. You avoid INR risk entirely. You only manage EUR/USD risk.
2. **Exchange-Traded Funds (ETFs) on NSE IX:**
   - Invest in **"GIFT Nifty"** contracts or specific US-stock ETFs available on the GIFT exchanges.
   - *Why:* These are dollar-settled instruments.
3. **Global Treasury Centres (For Corporates):**
   - If the client is a corporate entity, they can set up a **Global Treasury Centre (GTC)** in GIFT City to pool Euro cash and hedge centrally using Non-Deliverable Forwards (NDFs) with tax benefits.

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6. DUE DILIGENCE: FACTUAL & REGULATORY CHECKS

Use this section to satisfy Compliance/Legal teams.

[Fact 1] Is the Derivative Tax Exemption Real?

- **YES.** Refer to **Section 10(4E) of the Income Tax Act, 1961**. It explicitly exempts income arising from the transfer of Non-Deliverable Forward contracts, offshore derivative instruments, or over-the-counter derivatives entered into with an Offshore Banking Unit in the IFSC.

[Fact 2] Can Funds Trade Derivatives?

- **YES.** Refer to **IFSCA (Fund Management) Regulations, 2022**. Category III AIFs are permitted to employ complex trading strategies, including leverage and derivatives, for hedging or return generation.

[Fact 3] Is the "Euro Share Class" Legal?

- **YES.** Regulation 13 of the IFSCA Fund Regulations allows funds to accept monies and issue units in "freely convertible foreign currency." There is no restriction on issuing EUR units.

[Fact 4] Is Repatriation Restricted?

- **NO.** For foreign investors, funds in GIFT City are fully repatriable without RBI approval, as GIFT City is considered "non-resident" territory under FEMA regulations.

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7. RECOMMENDATION

To generate a "Fail-Proof" return that mirrors the Indian growth story without currency erosion:

1. **Select a Category III AIF** that explicitly uses a "Hedged Equity" or "Long-Short" strategy (utilizing the Section 10(4E) tax benefit).
2. **Mandate a EUR Share Class** to transfer the USD conversion risk to the fund manager.
3. **If EUR Class is unavailable**, execute a rolling **EUR/USD Forward Hedge** at the portfolio level (Synthetic Overlay).

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