



THE CASE FOR PASSIVE INVESTING IN INDIA

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Passive investing involves investing in a basket of securities that fairly represent the asset class the investor needs to invest. The objective of a passive investor is to earn the rate of return that the select asset class provides and is not beating the benchmark. A passive investor does not decide upon individual securities to buy or sell but rather their analysis is limited to the broader asset class.

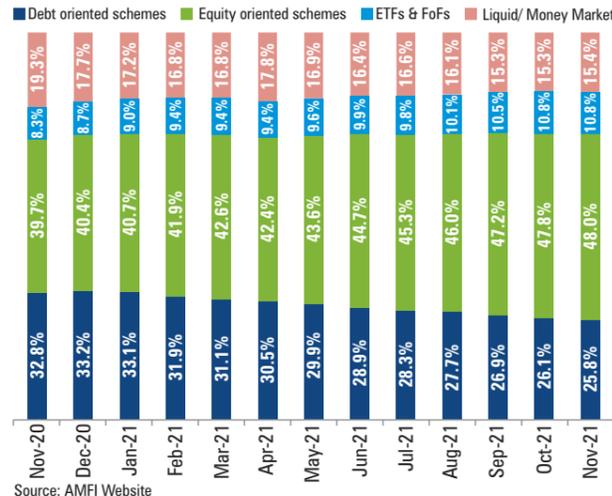
Passive investing is a concept that has its genesis in Efficient Market Hypothesis (EMH). As per Efficient Market Hypothesis, the price of security reflects all information and always trades at fair values on the exchange. Therefore, it is impossible to beat the benchmark. Stock selection or Market timing have no role in generation of alpha. Higher returns can be only be achieved by purchasing riskier investments. Advocates of EMH believe that investors benefit through Passive investments.

Passive funds have been in existence since 1975, they have grown in popularity over the last decade. As per a recent Bloomberg Report, Passive overtook active around August 2018 and its market share stands at about 54%, driven largely by the growth of funds tracking the S&P 500, the total U.S. stock market and other broad U.S. indexes. U.S. large-cap stocks are widely recognized as comprising the world's most efficient equity market, contributing to passive's dominance.

As per the latest Gallup Investor Optimism Index survey, conducted June 22-29, 2021 in US, a large majority of investors say that "passive investing" (71%) is superior to "active investing" (29%) to maximize returns over the long term.

These trends are catching at a fast pace in India too. Assets managed by the Indian mutual fund industry has increased from Rs. 29.83 trillion in November 2020 to Rs. 38.45 trillion in November 2021. That represents 28.89 % increase in assets over November 2020.

There a significant increase in ETF market share from 8.3% in November 2020 to 10.8% in November 2021. **Passive Funds now account for 10.8% of the Mutual Fund Industry AUM amounting Rs. 4.15 trillion.**



A passive investment strategy can be adopted through either Index funds or Exchange-Traded funds (ETFs).

Index Funds operate like a mutual fund scheme which mimic the performance of popular market indices (like Nifty 50, NASDAQ 100). The fund manager's role is restricted to tracking the changes in the underlying index.

Exchange Traded Funds are similar to an index fund, however it can be traded on the exchange like a common stock. **Holding a Dmat Account is mandatory for investment into ETFs.**



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Bonds, real estate, commodities, currencies, and multi-asset funds are all available in an ETF format. For instance, Mutual Funds in India offer Gold ETFs, where the underlying investment is in physical gold. A majority of Fund Houses have recently introduced Silver ETFs.

Key Benefits of Passive Investments:

- **Low Cost:** Management fees are generally very low compared to an actively managed fund
- **Consistently tracks the benchmark:** The performance of passive funds closely tracks the index and chances of wide variation in returns are minimised
- **Tax Efficient:** Since it is more of a buy and hold strategy, the capital gain liability is delayed.
- **Elimination of Human Bias:** It eliminates emotional biases since investment decisions are in sync with the components of the underlying index

The rising interest in passive investing India can be attributed to the following issues:

1. **Underperformance of Actively Managed Funds:** Majority of large cap funds have failed to beat the benchmark. As per recent SPIVA Report "Over the one-year period ending in June 2021, the S&P BSE 100 was up 55.96%, with 86.21% of funds underperforming the benchmark. Over H1 2021, 53.13% of the funds underperformed the S&P BSE 100. Over longer horizons, the majority of the actively managed large-cap equity funds in India underperformed the large-cap benchmark, with 65.93% of large-cap funds underperforming over the 10-year period ending in June 2021."
2. **Relatively Higher Cost of Active Investment:** Every active fund seeks to outperform index performance and needs more resources in terms of people, tools and processes to do the same which in turn leads to higher costs. Expense Ratio of actively managed equity funds in India is around 1.50%. However, the investment expense for passive funds can range anywhere between 0.05% to 0.40% . Passive investing can lead to significant cost savings in the long term.

Downside to Passive Investment

- **Tracking error:** Tracking error is the difference between the returns of Passive Fund and the benchmark it was meant to mimic. ETFs and Index funds, much like other mutual fund schemes, incur expenses on cost heads, such as marketing, advertising, office administration, brokerage and so on. These expenses reduce the ETF's returns. This deviation in performance is known as the "tracking error" and is expressed in percentage terms. How well an index fund manages its inflows and outflows also determines tracking error. The lower the tracking error, the better the ETF / Index fund.

- **No chance of outperformance:** Passive funds can never beat the benchmark it is supposed to mimic. The returns will move in perfect correlation with the index / benchmark the fund tracks. It is to be noted that dividends received by ETFs are reinvested into the fund. Dividend reinvestments can lead to temporary outperformance relative to the benchmark.

In India, IDBI Principal was the first AMC to launch an index mutual fund tracking Nifty in 1999. The scheme later became the Principal Nifty 100 Equal-Weight fund.

Benchmark AMC was the first to launch Nifty bees - an index exchange-traded fund (ETF) tracking the Nifty 50. Benchmark AMC was later taken over by Goldman Sachs, which was later acquired by Reliance Mutual Fund (now Nippon Mutual Fund).

Passive schemes have become quite popular in India. There are around 170 passive schemes in India. SBI ETF Nifty 50 India's largest Passive Scheme with an AUM of Rs. 1.22 lakh crores as on 31st December, 2021

Fund houses continue to roll out innovative research based passive schemes. About 50 passive schemes were launched in 2021 alone which managed to garner assets amount Rs. 1.5 lakh crore.

Financial literacy campaigns like "Mutual Fund Sahi Hai" have increased the awareness of financial products among a large section of investors. FinTech companies have played a huge role in driving investments into passive funds.

A recent report by Finity estimates that "Passive assets will grow to make up 37% of the overall assets in the mutual fund industry by 2025 from the 10% as of March 2021. The rise of passive investing is one of the simplest and yet among the most exciting trends that is happening in the Indian financial markets."

I personally expect that investors interest in passive investing will continue to rise and we will continue to see a steady increase in investments into Index Funds and ETFs in India. However, Passive and Active Investments will continue to co-exist in India for some years as we still have considerable room to increase efficiency in our markets.

Namrata Singh is the Founder of Arthasdhana Investments. She is a Certified Financial Planner with more than 14 years of experience in banking and wealth management. She also holds a MBA degree and is currently pursuing CFA (level 2).