EXCHANGE TRADED FUNDS IN INDIA

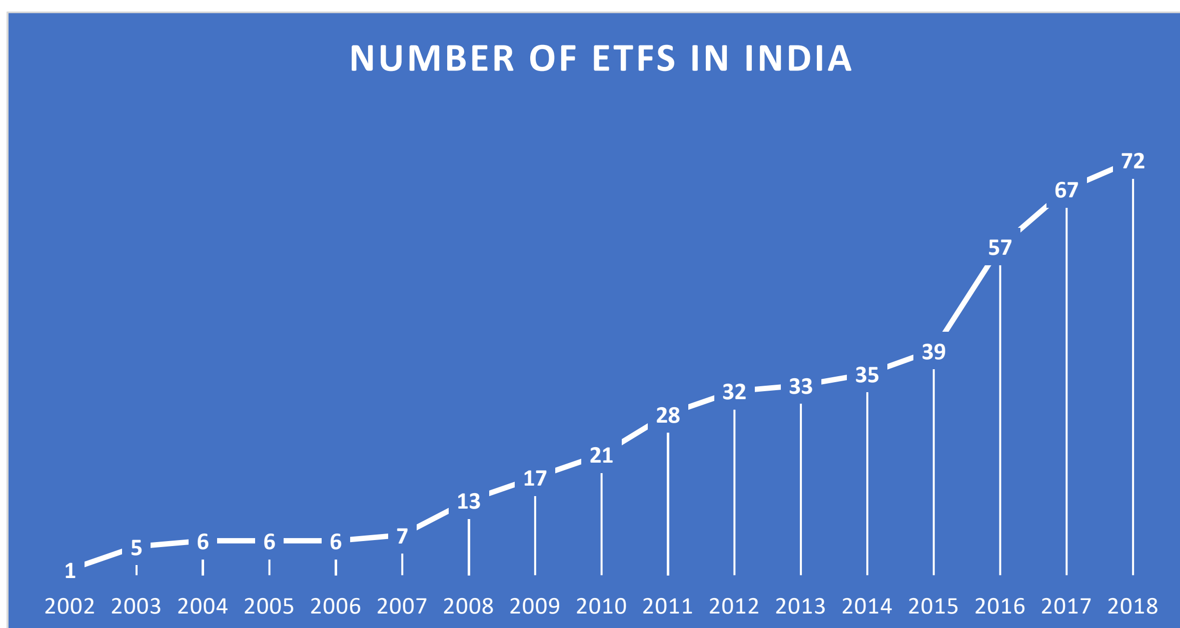
The Exchange Traded Fund (or ETF) industry in India is largely a market that could have a large amount of potential, yet they are often considered sub par when compared to other investments such as Mutual Funds. This paper aims to analyse the performance of ETFs in the Indian market by looking at data regarding their rates of return, cost, growth, etc; along with that, reasons for their underperformance and unpopularity will also be looked at briefly. Lastly, the paper will aim to analyse ETF data and make a case for their inclusion in the portfolio of investors in India.

So what are ETFs?

An ETF is a marketable security that tracks either an index, bond, commodity, or a basket of assets, and they can be traded on the stock exchange at any time during trading hours, just like a regular stock. ETFs are like mutual funds in the sense that they work on the same principle of pooling in investments for partial ownership of a stock, but they are significantly more flexible and cheaper than mutual funds. Another very important point to keep in mind about ETFs is that they are passively traded- funds that are automatically designed to match or track a certain index, and involve very minimal involvement from a fund manager like a mutual fund would require. Stocks of companies in an ETF are bought in the same proportion or weight as an Index to mimic it as closely as possible, however sometimes there are deviation from the returns produced by an index, commonly referred to as a 'tracking error'- higher the tracking error, the worse off an ETF is at replicating the index it is supposed to.

ETFS IN INDIA – AN OVERVIEW

ETFs were first introduced in India in January 2002, with the launch of the NIFTY BeEs. While initially slow to take off, consumer interest in ETFS took off a few years later due to the introduction of a variety of ETFs, including Gold ETFs. From a paltry 1 ETF in 2002, the number of ETFs on offer today in India number at 72.



The value of the AUM (Assests Under Management) in the ETF market in India is valued at **about 8 billion USD or 77000 crore rupees (**as of january 2018). This is in stark contrast to a developed country like the United States of America, where the ETF market is valued at 4.7 trillion USD, even though the ETF market has only existed in the US for about 8 more years (ETFs were introduced in the US in 1993).

GROWTH OF THE ETF MARKET IN INDIA

The growth of the ETF market in India when comapred to the mutual fund market has been extremely interesting. In the period between 2004 and 2018, the ETF market has grown from AUM 70 crore to 77000 crore; this is in comparison to the mutual fund AUM which has grown from 1.5 lakh crore to 22.86 lakh crore. When the two are compared, it is observed that the ETF market grew 1099 times, versus a 21 times growth in the mutual fund industry, showcasing the rapid growth of the upcoming ETF market over the past decades.

REASONS FOR THEIR UNPOPULARITY

Exchange Traded Funds are still in their nascent stages in the Indian financial scene and are heavily looked down upon when compared to mutual funds. There are a multitude of reasons for their lack of success and popularity in India, a few of which are listed below.

- Due to India being a developing market, the spread of information amongst all participants in the markets is not as efficiently spread out as it would be in developed countries. This disparity is exploited by fund managers of actively managed mutual funds, who have access to some information that regular investors may not, using this information to maximise their profits. It could be possible that as markets get more efficient in India, ETFs will start to outperform mutual funds on a consistent basis.

- Inability of the ETF to replicate the Index that it is attempting to track, possibly due to incorrect allocation of weights to stocks

- As of 2018, SEBI decided to bring about a decrease in the TER (total expense ratio) of mutual funds in India by capping it at 2.25%. This could incentivise people to further invest in them.

- While the SEBI-capped TER for ETFs at 1% is nothing but a boost for ETF investors, the lack of commission when compared to mutual funds disincentivises managers from recommending them. This is one of THE LARGEST problems in India- lack of awareness about ETFs. Managers would rather recommend an actively managed fund over a passive one as they would be earning a higher commission on the active fund.

- Lack of comprehensive data : There is a multitude of websites for countries like the US that have comprehensive data on ETFs in their respective country (like tracking error, expense ratios, etc). This allows casual investors to have a look at all the data and make an informed decision for themselves at their own convenience. In India, however, similar data is a lot harder to come across and a lot more time needs to be allocated for doing so.

- Lack of specialised ETF offerings : The Indian ETF market is still in its early stages; hence, there exists the lack of niche ETF offerings based on different themes and strategies such as sector indices, strategic indices, country-wise markets etc that are available in larger numbers in more developed markets.

One line of reasoning on why ETFs in India have not performed as well as ETFs in the US is that people believe Indian ETFs have a much higher tracking error and expense ratio. Due to this, people do not invest in ETFs in India as people believe they are subpar when compared to their foreign counterparts. However, an analysis of Equity ETFs in the country (as of Dec3, 2018), shows us that the Average Expense Ratio of these ETFs is about 0.23%, which is extremely competitive when coupled with an average one year tracking error of 0.36% (versus 0.53% in the US); thus making the claim unfounded. The caveat over here, however, is that the number of ETFs in the US is exponentially more, thus increasing the probability of a higher tracking error.

While this paper mainly focusses on the concept of index tracking ETFs in India, it would be unfair not to talk about gold ETFs in a gold obsessed country like India. In 2014, gold accounted for almost 1/3rd of all ETFs listed on the Indian market . Gold ETFs, or any other commodity tracking ETFs for that matter, differ from index tracking ETFs in the manner that the only return an investor could expect would be from an increase in their price; this is unlike Index tracking ETFs which provide returns through dividends declared by companies. Investing in gold ETFs are a much better bet than investing in physcial gold itself, as concerns related to storage and safekeeping are avoided. However, one peculiar trend that seemed to emerge through an analysis done on Gold ETFs in India, was the extremely high tracking error exhibited by these ETFs- in some cases as high as 6%.

CHANGING SCENARIO IN THE ETF MARKET

The ETF market is still developing in India. Many people choose to invest in mutual funds on the basis of the returns that they exhibit. Up until February 2018, active funds such as mutual funds, compared their returns to the *plain vanilla* index returns i.e the simplest form of the index that did not include dividends declared by the companies, not the Total returns index. This led to the appearance that most mutual funds were outperforming their benchmarks when in fact, they were not. However, post February, SEBI has mandated that only the TRI can be tracked by funds. This would significantly drive down the outperformance (and in some cases even signify underperformance) of these actively managed funds, helping make a case for passive funds.

Fund houses have started to understand the needs and tastes of the highly developing Indian market. As stated above, one of the disadvantages ETFs have in India is the lack of specialised ETFs that cater to specific categories. However, as the ETF market has developed, there have been more specialised ETFs that have been launched on the basis of value, quality, dividend opportunities, etc. For example- The S&P BSE Greenex tracks the performance of the top 25 “green” or environmentally friendly companies, Reliance ETF Shariah BeEs only invests in companies that are shariah investment compliant

(excluding companies that are involved in certain sectors like alcohol, gambling etc), amongst many others. However, there is still a long way to go and the market must keep developing.

A CASE FOR ETFs IN THE INDIAN MARKET

Exchange Traded Funds in the Indian environment could prove to be a useful tool in increasing participation in the financial market. According to statistics, only a meagre 1% of the population actively takes part in the stock market, and this figure rises to 2.5-3% when we consider indirect participation i.e- mutual funds. Only 15% of India's wealth exists in financial assets, when compared to 70% in the US, and 40% in China. A developing country like India requires more participation in its financial markets to grow just as countries like the US and China have; especially in India, where majority of the savings are channelled into commodities such as gold (physical purchase), which do not benefit the economy as much as investing in the financial sector would. Apart from widening India's trade deficit and causing an unnecessary rise in the country's import bill, the economic growth brought about by purchase of gold when compared to investing in stocks and bonds is negligible.

So why ETFs? ETFs serve as a gentle introduction into the world of investing for people with little to no experience in the field. Considering how most ETFs mirror an already existing index such as the SENSEX or NIFTY by consisting of the same stocks in the same weightage, the entire headache of cherry-picking stocks ceases to exist- investors merely need to trust in the growth of the index as a whole instead of individually tracking certain stocks, referred to by ace investor Warren Buffet as 'sit on your ass' investing. Even when compared to mutual funds, ETFs seem to have an inherent advantage for beginners. Firstly, ETF expense ratios usually hover around somewhere as low as 0.1-0.2% and not more than around 1%, whereas mutual fund expense ratios could be as high as 2.25%. This massive gap in expense ratios could entice investors towards ETFs, especially as they are looking to maximise every rupee that they put into a fund. Next, again, the entire headache of figuring out which mutual

funds consist of the best investments; while this may not involve as much effort as actively investing, it is definitely more work than investing in an ETF. And lastly, while not as pertinent when we are considering an Indian scenario where funds would most likely be parked on a long-term basis, ETFs enjoy the benefit of higher liquidity as they can be traded during the day just like any normal stock. This provides a much better alternative to some mutual funds where funds are locked in for a definite time period, significantly decreasing their liquidity.

Moreover, the utilisation of ETFs as a tool to **spread financial literacy** could definitely be a possible scenario. The idea behind this is the domino effect that will take place- once people start seeing that their fellow peers are making money through investments, they would also like to try their hand in the same, and so on and so forth. As stated before, the simplicity of ETFs and the fact that extensive knowledge is not required to invest in them could lead to people trying to catch on to the trending of investment specifically through ETFs. It is imperative that households are educated and convinced to take part in the financial system for the sake of the country's development.

The only disadvantage that ETFs might have in the Indian context is that a *demat account* needs to be opened to invest in them, unlike mutual funds which merely require a bank account. A demat account is an account that is used to hold shares and securities in an electronic format. India has a population of 858 million in the 15-64 age category and seeing as there are only 31.6 million demat accounts open in the country (3.68% of the population considered above), India has a long way to go in terms of demat account opening. Even then, the general sentiment amongst demat account holders would be to invest in shares rather than ETFs, which are still in their nascent stages in India.

EXPENSE RATIOS

The trump card that ETFs have, something that is a huge driving point in their favour, is their extremely low Expense Ratios. Considering the Average equity ETF Expense Ratio hovers around 0.25%, returns on ETFs are maximised when compared to mutual funds which have higher Expense Ratios, the average being around 2.1%!

While this difference might not seem like much, take the following example: Say you were to invest 1 crore each in ETFs and Mutual Funds. The amount lost on this investment of 1 crore over 1 year would be 30,000 for ETFs and 2 lakh for Mutual funds, and the difference between the two would only keep compounding as years go by.

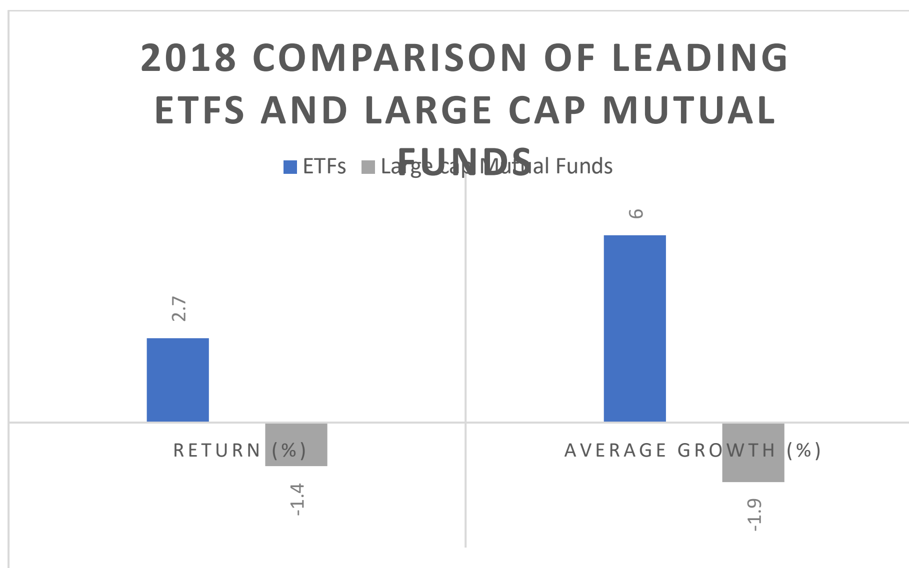
ETF expense ratios will only continue to go lower and lower as the Indian market gets more developed, a trend that occurred in the US market as it developed over the years. As a matter of fact, for the top 10 ETFs in terms of AUM in the Indian market, the expense ratios go as low as 0.05%! Value investors will definitely see the benefit provided by these low expense ratios as the market keeps developing.

QUANTITATIVE ANALYSIS OF ETF PERFORMANCE IN INDIA

For a comprehensive argument to be made in favour of ETFS, it is essential that a quantitative analysis on the returns provided by them be done :

A case for the move from actively managed to passively managed funds in India is the recent underperfomance of mutual funds in India. Economic Times,

through data sourced from Accord Fintec, reported the following mutual fund performance in 2018 – only 2 of the 32 large cap and 24 large- & midcap schemes, and just 6 of the 33 multi-cap schemes beat their benchmarks. Continual lagging behind of these funds could cause a shift towards low-cost Exchange Traded Funds in the country; ETFs have also been exhibiting much better performance- Average ETF returns for the year 2018 stood at 2.7% compared to a 1.4% decline in large-cap mutual funds**.** Best performing ETFs have gained 5.2- 7.6% during the last one year versus large-cap MFs that have dropped 1.1-2.8%. This continual lagging behind of mutual funds, coupled with the increasing regulations being imposed on fund houses with regard to their creation could be the catalyst that puts ETFs in the limelight in India.

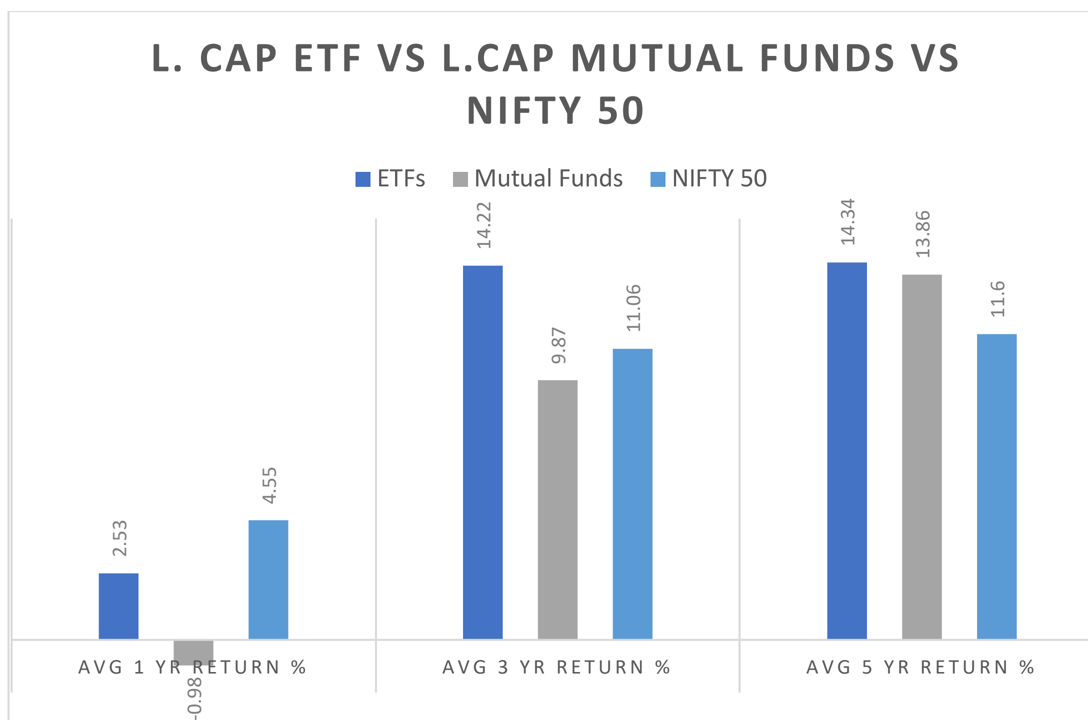


SHORT TERM COMPARISON OF ETFs & MUTUAL FUNDS (2018)

While the chart above shows how well ETFs have done in the past year, the outperformance shown by the could be a one off incident due to certain anomalies in the market, hence no concrete conclusion can be made. Could it be possible that mutual funds do better on a long term basis when compared to ETFs? To get a better idea of the big picture, a long term analysis covering the last 5 years would shed some light on how ETFs have compared in terms of returns when compared to mutual funds.

A Sample of 15 Mutual funds and 15 Equity ETFs were chosen. Owing to the lack of substantial number of ETFs amongst different capitalisation categories in India, the comparison is made between large-cap mutual funds and large-cap ETFs. Returns were compared over a 1,3 and 5 year data period, and to ensure accurate representation of the market, the chosen sample covers >90% of the market in terms of AUM in their respective markets. These returns are compared with a benchmark index as well.

	Avg 1 yr return %	Avg 3 yr return %	Avg 5 yr return %
ETFs	2.53	14.22	14.34
Mutual Funds	-0.98	9.87	13.86
NIFTY 50	4.55	11.06	11.60



LONG TERM COMPARISON OF ETFs, MUTUAL FUNDS, AND NIFTY 50

Our initial aim was to make a case for ETFs in India, and judging by the comparison of returns given by both over a 1,3 and 5 year period, we can see that ETFs consistently outperform mutual funds in terms of returns over the chosen time periods; in fact, giving us positive returns in a year when mutual funds produced negative returns. Returns may just be one aspect of comparison, but this contributes significantly to the case that is trying to be made in favour of ETFs. A definite conclusion that ETFs are going outperform mutual funds can only be made when ETFs start to beat mutual funds over a 7 or 10 year period. Unfortunately, most Indian ETFs have not even been in existence for that long, hence it is impossible to draw a trend that could be followed. However, if the current performance of ETFs continues on the track it is on then they will outperform mutual funds on a consistent basis. ETFs also beat the chosen benchmark index in our analysis; while this may seem like a good thing, continual significant outperformance could lead to a high tracking error, disincentivising ETF investment.

What would give us a better idea in terms of how well ETFs do versus mutual funds in other markets, it is important that a comparison is made with the country spearheading the ETF market, the United States. Making a similar comparison in the American context (Large Cap ETFs vs Large Cap Mutual funds), we obtain the following results – Mutual Funds outperform ETFs on a 1 year basis giving -4.62% return vs -5.19% from ETFs. In the 3 and 5 year period however, ETFs give a return of 9.12% and 8.48% respectively vs 7.57% & 5.45% for mutual funds. While Large cap is only one part of the different categories these funds consist of, the outperformance by ETFs was an expected result, seeing as how popular they are.

	1 yr return %	**3 yr return%**	**5 yr return %**
ETFs	-5.19	9.12	8.48
Mutual Funds	-4.62	7.57	5.45

Large Cap ETFs vs Large Cap Mutual Funds in the US

Another very valuable observation that can be taken from the United States is the reason why ETFs became so popular in the US. After the 2008 financial crisis, people realised that their regular equity holdings and most mutual funds were not diversified enough to protect them in the event of a financial crisis, and this spiked interest in ETFs. In the 10 years since, the ETF market has grown from 531 billion dollars to around 3.4 trillion dollars today. This sudden surge was brought about by the need felt by investors to diversify their holdings, and simultaneously doing so at a cheaper cost, thus the preference over mutual funds. Many people also decided to forego actively managed funds as they felt let down by their fund managers who could not prevent them from losing money in the crisis. A significant allocation of resources was made by companies such as Vanguard and Black Rock to promote ETFs and boost investor education regarding them. After seeing their money vanish from right in front of their eyes, people realised that it was time for something new, hence the push towards ETFs. Now, back to the Indian context- considering the financial crisis acted as a catalyst in this process, could it be possible that it's going to take a similar event taking place in India to make people realise passive funds could be a great alternative to actively managed ones? Investors need to be educated and fund houses need to be encouraged to push out the idea of investing in ETF if interest in them is to be generated without the occurrence of such an event.

The following has been observed

1) ETFs beat large cap mutual funds in terms of returns over the past 1,3 and 5 year period
2) ETFs beat sample benchmark index on a 3 and 5 year basis.
3) ETFs have substantially lower Expense Ratios when compared to Mutual Funds
4) ETF offerings are on the rise in India
5) The ETF market is increasing at an exponential rate year over year