An Investor Education Initiative
MIRAE ASSET
Mutual Fund
by Mirae Asset Knowledge Academy

Investing in ETFs - a global trend that is taking India's fancy

Rising investor awareness and low cost are among the reasons for making ETFs a market favourite.

Exchange traded funds (ETFs) have emerged as a global force to reckon with, accounting for ~11% of the global regulated funds industry. Worldwide, the total net assets in ETFs stood at $6.3 trillion as of end-2019, with the world's largest financial market, the United States (US), alone accounting for ~70% or ~$4.4 trillion of assets.

After a tepid start in India, ETFs are increasingly finding favour with investors, led by its adoption by major institutional players such as the Employees' Provident Fund Organisation. ETF assets topped Rs 1.86 lakh crore as of June 2020 compared with mere ~Rs 450 crore in June 2004.

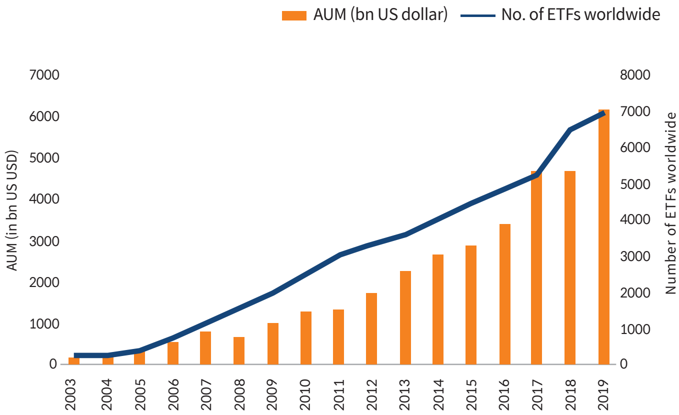
Source : CRISIL Research.

What has turned in favour of ETFs globally? Is it expected to sustain? What can we expect from the Indian market? These are some of the questions this article seeks to analyse.

Worldwide growth

ETF as a concept first came into picture in 1989, 1) by launching Index Participation Shares to track the S&P 500 and 2) Toronto 35 Index Participation Units to track the Canada's major index. However, they came into the limelight with the launch of US' S&P SPDR (Spiders), which started trading in 1993. Today, there are~7,000 ETFs worldwide with ~3,000 in the US alone.

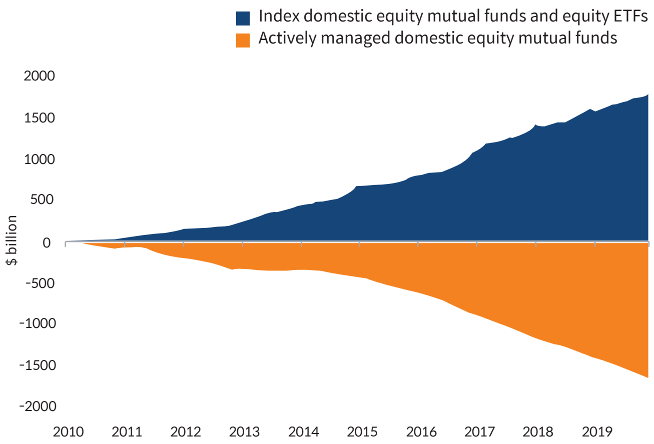
Number of ETFs worldwide have doubled in six years



Note: AUM – Assets Under Management
Source: Statista.com

Not only has the demand for investment in ETFs picked up, the global fund industry has seen outflows from long-term mutual funds being funnelled into ETFs. As per data from the Investment Company Institute in the US, from 2010 through 2019, index domestic equity mutual funds and ETFs received $1.8 trillion in net new cash and reinvested dividends, while actively managed domestic equity mutual funds experienced a net outflow of $1.7 trillion (including reinvested dividends).

Inflow into/outflow from the US mutual fund industry

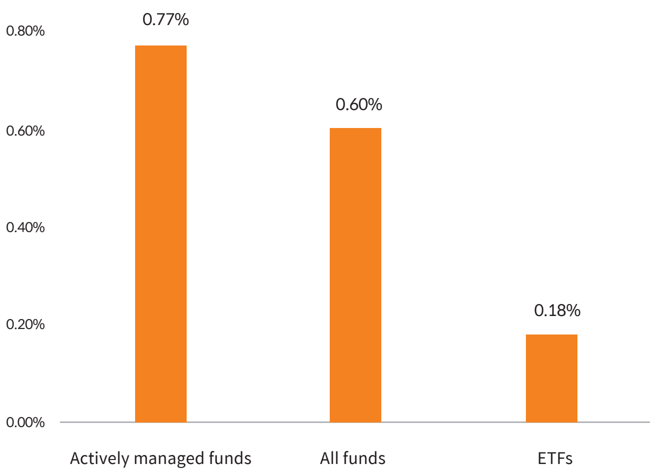


Source: Investment Company Institute Factbook 2020

The growth of the industry has been led by a myriad of factors, but the major ones include:

Low cost - Lower costs are associated with ETFs compared with actively managed mutual funds. As per Blackrock's report titled 'Four big trends to drive ETF growth' the asset-weighted average expense ratio across US open-ended funds was 0.18%, compared with 0.77% for actively managed funds.

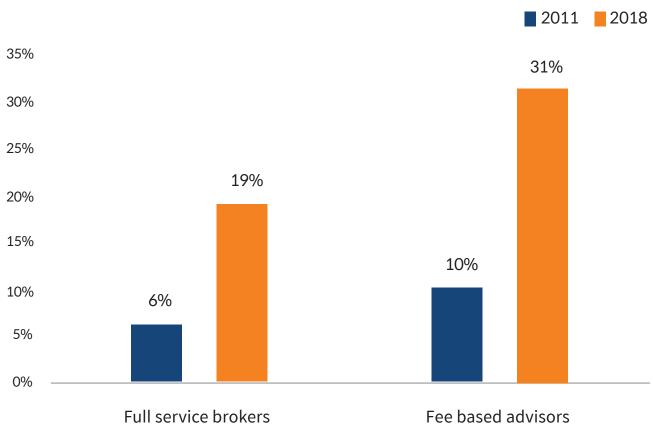
Comparison of expense ratio charged across actively managed funds in the US (2015)



Source: Blackrock report titled 'Four big trends to drive ETF growth'

Shift towards advisory model of intermediation – Globally, we are seeing a tectonic shift towards fee-based investment advisory model compared with the traditional commission-based distribution model, providing an impetus towards efficient low cost products such as ETFs. As per data from Investment Company Institute, in 2018, full-service brokers and fee-based advisers had invested 19% and 31%, respectively, of their clients' household assets in ETFs, up from 6% and 10%, respectively, in 2011. Further, as per Ceruli Associates and Blackrock estimates, the assets in the US fee-based advisory is expected to grow from $11 trillion as of end-2015 to ~$20 trillion as of end-2020.

Fee-based advisers are driving larger portions of client portfolios toward ETFs

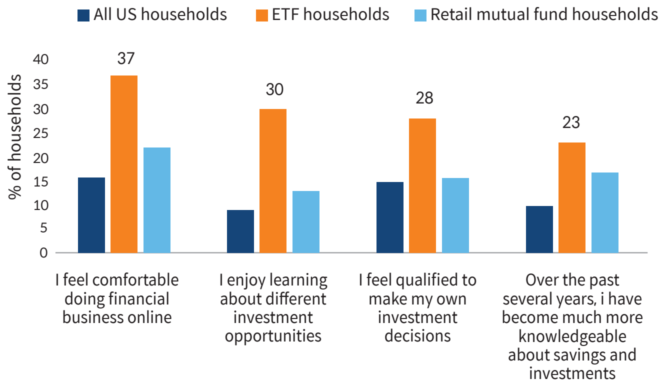


Source: Investment Company Institute Factbook 2020

Meanwhile in Europe, implementation of the Retail Distribution Review (RDR) in the United Kingdom (UK) and markets in financial instruments directive II (MiFID II) have given a push towards transparency of distribution income and thereby, a thrust towards advisory model of business.

Higher investor awareness of investments – The rise in ETF assets is also being driven by a segment of investors who are increasingly more aware of their investments. As per a 2018 report 'A close look at ETF households' by the Investment Company Institute and Strategic Business Insights, ETF households are more self-reliant and confident about investing. About 37% of ETF households mostly agreed that they feel comfortable doing financial business online, while 28% of ETF households felt qualified to make their own investment decisions. This awareness and confidence is also corroborated from the fact that 19% of the ETF households were aware of robo-advisory concept compared with just 7% for mutual fund households. This higher awareness of investors coupled with benefits of asset allocation with diversification in strategy has aided in the growth of the segment in investment planning worldwide, especially in the US.

ETF households in the US are more confident about making investment decisions

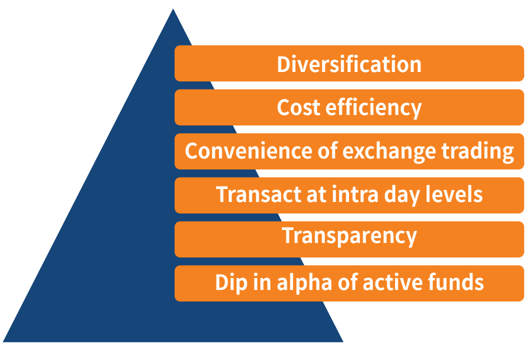


Source: 'A close look at ETF households,'2018, Investment Company Institute and Strategic Business Insights

ETFs are making fast headway in India

ETFs are on a strong forward momentum in India of late, despite a slow start. Opening up of pension funds to invest in equities was an important catalyst.

Other reasons for rising popularity of ETFs



Various reasons of growing popularity of ETF in India are:

Diversification: ETFs are available across various asset classes, which help investors based on their risk profile, reap the benefits of diversification by taking focussed and transparent exposure in various segments of the market. In the equity asset class, ETFs are available on local stock market benchmarks, some global equity benchmarks and on various sectors such as banking, consumption and infrastructure. In case of fixed income asset class, ETFs are available on government securities and money market instruments. ETFs under the commodity asset class are available in the form of gold ETFs, which are quite popular among investors.

Cost efficiency: One of the major advantages of ETFs is its cost efficiency vis-à-vis actively managed funds. For example, the latter can charge investors up to 2.25% as an expense for managing their funds, compared with ETFs which charge around 0.05-1% for equity-oriented ETFs. While the difference in expense appears nominal at first glance, it gets compounded over the long term. The absence of active management results in lower fees for ETFs.

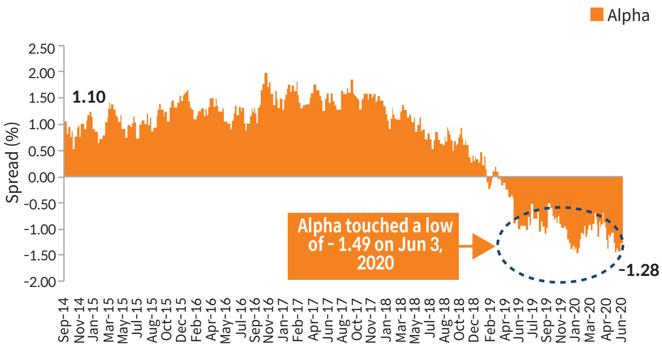
Convenience of exchange trading: Unlike other mutual funds, ETFs are traded on stock exchanges which gives investors the flexibility to buy/sell them at their convenience (depending on the liquidity of a scheme).

Transact at intraday levels: ETFs, unlike any other funds, are transacted at intraday prices, which corresponds to the indicative net asset value of the ETF at that time. Hence, the investor is able to buy or sell the ETF at the desired index/market levels, whereas in case of active mutual fund or Index funds, transaction is carried out on the basis of day close NAV.

Transparency: Another benefit of an ETF is that its portfolio is disclosed on real time basis, which makes it more transparent for investors as against other mutual funds where portfolio is disclosed on a monthly basis.

Dip in alpha of actively managed funds: With the consistent development of the Indian financial markets over the years due to a number of regulatory reforms by the capital market regulator Securities and Exchange Board of India, coupled with the continuous improvement in technology, the markets are becoming more efficient. This means finding ways to beat the market is becoming more and more difficult, in other words, consistent alpha generation has become challenging. This trend is already visible in the form of a dip in alpha from actively managed funds over benchmarks, as shown in the chart below.

Alpha returns of actively managed funds vs. benchmark have dipped in recent times



Note: Alpha is the difference between the daily five-year annualised rolling returns of a weighted large cap fund performance index based on CRISIL-ranked large cap funds, and Nifty 50 TRI as on June 30, 2020.
Source: CRISIL Research

An ETF-ready future

The future of ETFs looks bright both globally and in India, for a number of reasons. One common reason is its low cost, which is a sensitive aspect for all investors. Two, the move towards advisory model of financial intermediation globally, which is still in a nascent stage back home, is expected to grow with a push from the regulator, thus increasing demand for low cost products like ETFs. Three, investor awareness is on the rise in India, especially among high net worth individuals, as seen from their higher adoption of the product in recent times. Fourth, with ETFs, the investor can take focussed and transparent exposure in various asset classes or segments of the market depending on his/her risk profile and create a model portfolio. All this will continue to help propel investors towards the segment.

Two more crucial factors are expected to benefit ETFs specifically in India - the low development of the category and the mutual fund industry as a whole, which is still restricted mostly in T-30 cities and rising market efficiency. Higher penetration and greater proportion of financial savings, coupled with reasons mentioned above, could see investors gravitate towards low cost, simple and efficient products like ETFs in the country. And, as the market gets more efficient and real time information rises, it will become more difficult for active funds to beat the benchmark, thereby making ETFs look more enticing for investors.