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ETFs AND THEIR SUITABILITY IN PORTFOLIOS

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The rise of ETFs & Passive Investments

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Since their debut, Exchange Traded Funds (ETFs) and passive investments have seen a tremendous growth globally. They continue to capture a bigger market share every year as their popularity grows. Today, the ETF industry commands over US$5 trillion in assets globally, growing at an average annual rate of about 20% since the financial crisis of 2008.

There are more than 7,200 ETFs worldwide trading on 60 Exchanges with more than 25% of total ETFs in the US alone. The top 15 most traded ETFs in the US account for more than 50% of total ETF trading volume and their liquidity is such that they attract the world's biggest foreign institutions. In fact, the traded value of ETFs in the US each year is approximately US$20 trillion, more than the entire GDP of the US which is approximately US$18.4 trillion *(Source: Bloomberg Markets: Everything You Need to Know About ETFs Right Now: Intelligence by Eric Balchunas).*

While ETFs account for a 13% market share in the US, they still have a lower penetration rate in Europe and other global markets. However, increasing focus on cost transparency and changes in regulatory framework and market structure will further fuel the growth in the market for index tracking products. PwC in its report titled "ETFs – A Roadmap to Growth" expects assets in passively managed funds to exceed US$7 trillion by 2021

Index Funds and ETFs can be viewed as the Netflix or Uber of the asset management industry, disrupting and redefining investment management through low cost innovative products.

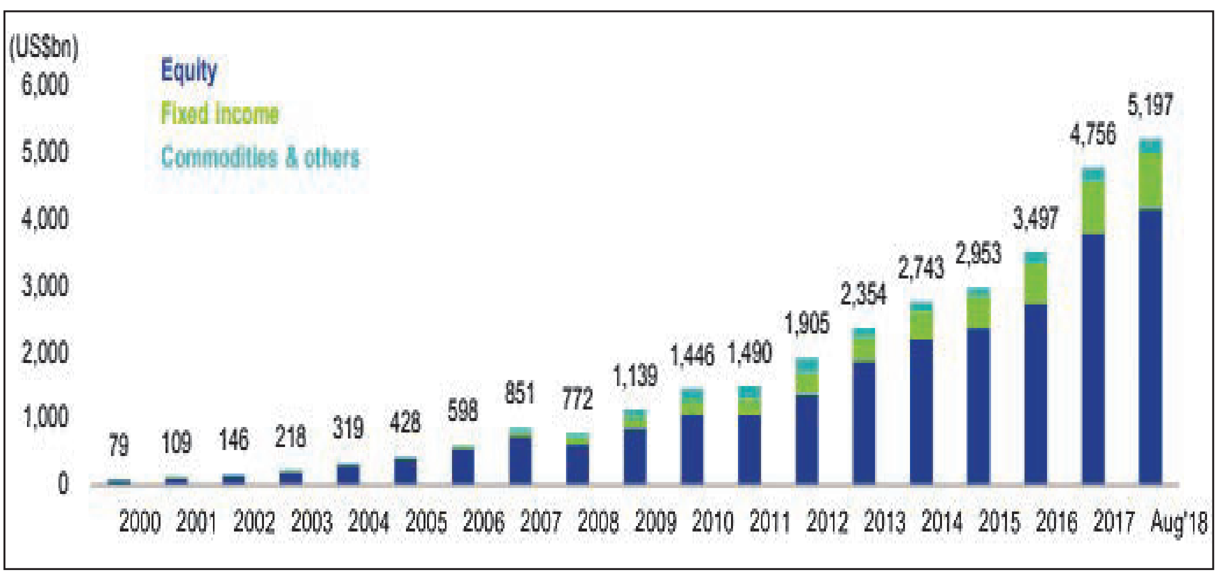
Index Funds are just like any other mutual fund in terms of structure, except that they seek to provide returns in line with the underlying index they track. Units of an index fund are issued at closing NAV. An ETF on the other hand can be viewed as an index fund that trades on an Exchange just like a stock! Units of an ETF can be bought and sold throughout the day on the stock exchange. It is a marketable security that tracks an index, a commodity, bonds or a basket of assets like an index fund.

In India, the first ETF – Nifty BeES, was launched in 2001 by Benchmark Asset Management Company. While the response to onshore ETFs in India was initially relatively muted, as compared to traditional Mutual Funds, passive investments were popularised by the success of Gold ETFs and subsequently through Government of India's disinvestment program through the ETF route. The phenomenal participation that these funds have received has definitely created a buzz around passive investing in India. This has had an overall positive impact in terms of enhanced awareness about passive investments with ETFs and index funds having found favour from institutions.

The passive industry in India has grown phenomenally over the past decade from Rs.8,900 crores in 2008 to over Rs.1 lakh crore in August 2018 *(Source: MFIE)*. However, it still accounts for a small fraction of Rs.25 lakh crore Indian mutual fund assets as active fund management has a much longer history and natural appeal due to its potential to outperform the benchmark in India. Although the mutual fund industry has registered a rapid growth in assets over the last decade, India has one of the lowest mutual fund investments to GDP ratios at 11%, signifying an untapped opportunity for further growth in the mutual fund industry. The average Mutual Fund assets globally as a percentage of GDP are in the range 15% whereas in peer Asian economies like Thailand, Korea and Malaysia, this ratio is between 25% and 30%. In the US the MF assets to GDP ratio is more than 100%, and in Hong Kong and Singapore this exceeds 400%. *(Source: World Bank - Non banking financial database)*

In recent times, there is more focus on increasing penetration of the mutual fund industry. Growth of digital technology has also helped fund houses to enhance their distribution reach. Permitting payment banks to sell third-party MF products through their platforms has further revolutionized

Global ETP Assets



Source: BlackRock Global ETP Landscape, Aug 2018

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Growth of Indian ETF Industry

2001:
Slow Start & Product Development:
- First Equity ETF launched
- Focus on product development
- Focus on highlighting advantages of passive management / indexing
- Used primarily by retail investor base

2007:
Success with Gold ETFs:
- Gold ETFs widely embraced by retail investors
- Traditional MFs explore ETF market / launching FoF products with Gold underliers
- International / sector / thematic / G-Sec ETFs launched

2013:
Growth facilitated by regulatory changes / government disinvestment:
- Measures addressing ETF specific hurdles taken
- CPSE ETF - Launch of Government disinvestment ETF with innovative features

2015:
Opening of Pension Markets for ETFs:
- Pension Funds and Retirement Trusts mandated to invest a minimum of 5% of incremental corpus in equity
- EPFO opts for ETFs for equity allocation
- Ongoing flows from EPFO / Exempt PF Trusts / Gratuity / Superannuation funds for equity allocation
- ETF industry becomes mainstream; 16 asset managers launch ETF schemes
- Government launches CPSE ETF FFO / considers SUUTI disinvestments through ETFs

2017:
Further expansion in ETF space:
- Additional tranche of CPSE ETF
- Launch of Bharat 22 ETF

2018:
Continued expansion of ETF:
- Proposal for creation of Debt ETF for PSUs and public sector banks
- Second tranche of Bharat 22 ETF launched

the reach and efficiency of mutual fund industry.

Mutual fund regulator SEBI has also been pushing for increased transparency, focus on lowering expense ratios and deepening mutual fund product offerings. Scheme re-categorization, which has come into effect since April 2018, and a move to report *Price Returns Index* from hitherto *Total Returns Index*, for benchmarking performance are some of the changes that will augur well for the passive segment. Additionally, ETFs and Index funds are expected to get a further boost with SEBI's focus on advisory models and driving the growth of direct plans to increase retail participation.

Any investor looking to access the markets at a reasonably low cost can consider investing in ETFs and Index Funds as part of his or her overall asset allocation. Investors may expect better risk-adjusted returns by having a core portfolio of passive funds that grow in line with the broader market, while a satellite portfolio can be intensively managed to generate Alpha. This can be easily achieved with a core allocation to low cost products like ETFs that have become building blocks for today's more dynamic, diverse portfolios providing access to a range of asset classes and global markets. Since they trade just like stocks, ETFs give investors the ability to adjust their portfolios nimbly and efficiently as markets shift. A satellite exposure to equity can be taken through investments in either direct stocks or actively managed funds.

While the debate on whether Active managers have the potential to outperform Passive will continue from a global context, what Indian investors really need is a blend of both. There is a need for adopting both styles through a "Core & Satellite" approach to portfolio management in order to mitigate the risk of underperformance. FPJ