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with traditional mutual funds



**IN
CONVERSATION
WITH**

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Exchange Traded Funds (ETFs), as a mutual fund category, have just turned 30 this year. It was three decades ago, or on January 22, 1993, to be precise, when the world's first ETF—S&P 500 ETF Trust—hit the market in the United States. Its overwhelming success spawned similar products in America and elsewhere. According to Statista, an online platform specializing in market and consumer data, there were 8,754 ETFs globally in 2022, compared to 276 in 2003. Globally, assets under management (AUM) in ETFs, though, are only a fraction of the total financial market. ETFs represent 12.7% of equity assets in the US, 7.8% in Europe, and 4.1% in Asia-Pacific, shows iShares data. In India too, awareness about ETFs is slowly but surely increasing. In an exclusive interview with Amit Singh Sisodiya, Deputy Editor, *The Global ANALYST*, Sailesh Jain, Fund Manager - Equities, Tata Mutual Fund, talks about the significance of ETFs as a mutual fund category, their key features, the advantages they enjoy over traditional funds, the risks an investment in these funds may entail, and his outlook on the category.

Edited excerpts >>>

■ **ETFs are celebrating 30 years of their successful existence this year. It was three decades ago, or on January 22, 1993, when the world's first exchange-traded fund, the S&P 500 ETF Trust, debuted in the US. What is your view?** ETFs, or Exchange-traded Funds, are flexible and easy-to-trade funds listed on the stock exchanges. They try to mirror the underlying index, and investors can buy and sell them like stocks, typically through a brokerage account. The journey of the S&P 500 ETF has been quite outstanding. The S&P 500 ETF Trust, also known as SPY ETF, is one of the most popular ETFs listed on the US exchanges, and it allows investors to take access to all the S&P 500 stocks in one investment. One of the most attractive features of SPY

is the low expense ratio of 0.0945%—the lower the ratio, the better for the investor. This ETF made its debut with just \$6.5 mn in assets. Today, it is the largest ETF in the world with around \$355 bn in AUM and an average daily trading volume of around 39 billion.

■ **How has been the experience in India so far as far as this revolutionary product is concerned?**

The journey of ETFs as a category in India has been quite slow, but it, of late, is gaining momentum. As awareness of the product and its benefits were realized, in the last few years, we saw significant interest from investors. The current ETF AUM (all) stands at ~ 6.5 lakh cr. ETFs based on Nifty underlying are

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quite popular, the largest individual ETF is ~ 1.45 lakh cr and is based on Nifty as it is under (as of 24-4-23, Source: AMFI website).

■ **Do you think ETFs have been a game changer, contributing to the great penetration of mutual funds in India?**

The growth in ETFs can be attributed to some of the steps taken by the government. In the 2013 budget, ETFs were recognized as an eligible asset class for pension funds. Since 2014, the government has also taken the ETF route for disinvestment. In 2015, the Employee Provident Fund Organisation (EPFO) decided to invest 5% of increment in flows into ETFs.

The underperformance of the active funds vis-à-vis the underlying also led to the buying of ETFs.

Below are some of the benefits of the ETFs that made them game changers:

1. ETFs are listed on the exchange and can be traded like a stock during trading hours.
2. Ability to put limit orders.
3. Transparency, as it tries to mirror the underlying index.
4. The minimum investment is one unit.
5. Expense ratio is lower.
6. Protects long-term investors from the impact of cash flows from short-term investors; since it is traded on the exchange.

■ **How different are they from other types of mutual funds?**

ETFs trade like stocks and therefore offer a degree of flexibility unavailable with traditional mutual funds. In a traditional mutual fund, investors can only purchase units at the fund's NAV, which is published at the end of each trading day. ETFs are immediately tradable, and consequently, the risk of a price differential between the time of investment and the time of trade is substantially less in the case of ETFs. This difference gives rise to an important advantage of ETFs over traditional funds. ETFs tend to be cheaper than traditional mutual funds and index funds in terms of fees. However, while investing in an ETF, an investor pays a commission to the broker. The tracking error of ETFs is generally lower than traditional index funds due to the "in-kind" creation/redemption facility and the low expense ratio.

■ **Do they also offer the benefit of investing via SIP?**

Yes, investing in an ETF through systematic investment plan (SIP) is similar to investing in any MF scheme. What is important is the discipline in investing while using the SIP route.

■ **What is the market size of ETFs in India?**

The Indian ETF market, including all Asset classes is close to 6.50 lakh crore, as on 24-4-23 (Source: AMFI website).

■ **It is said they offer the convenience of passive investment as well as lower expenses. What is your view?**

Yes, ETFs are passively managed funds, trying to mirror the underlying index and hence the fees are much lower compared to an actively managed fund. Since ETFs are passive funds, they lack emotional bias on the part of the fund manager. For example, an investment in a Nifty 50 ETF, would deploy into a well-diversified portfolio of well-known companies as represented by the Nifty 50 Index.

■ **What kind of investors can invest in ETFs? Whom do they suit the most?**

A broad class of investors can use ETFs:

1. For retail or wholesale investors with a long-term horizon, it allows diversification of portfolios with one single investment. Lower costs of ETFs enhance net returns in the long-term.
2. For FIIs, institutions, and mutual funds, it allows easy asset allocation, hedging, and equitizing cash at a low cost; cash equitizing is a strategy whereby an investor can transform his cash into an investment that will track his/her benchmark.
3. For arbitrageurs, it provides ease with a low impact cost (the cost of executing a transaction in a given stock for a specific pre-defined order size, at any given point of time) to carry out arbitrage between the cash and the futures market.
4. For investors with a shorter-term horizon, ETFs provide access to liquidity due to their ability to trade during the day and at values near NAV.

■ **It is assumed they entail less or no risk compared to other types of mutual funds. Is it true? If not, then what are the biggest risks one gets exposed to while investing in these funds?**

ETFs try to mirror an underlying index, and hence they are more diversified if the underlying is a broader in-

dex. Following are some of the risks to which an ETF investor gets exposed:

Market Risk: ETFs are subject to market risk, just like any other investment. The value of an ETF can fluctuate with changes in the underlying assets.

Tracking Error: ETFs may not always track their underlying index perfectly, which can result in a “tracking error,” where the ETF’s performance deviates from the index.

Trading Costs: While ETFs typically have lower expense ratios than actively managed mutual funds, they can still incur trading costs, such as brokerage fees, transaction costs, and taxes, which can impact returns.

Reduced Flexibility: Unlike individual stocks or mutual funds, ETFs cannot be customized to meet specific investment goals or strategies. This can limit an investor’s ability to tailor their portfolio to their individual needs.

Liquidity: Although ETFs are generally liquid, the liquidity of specific ETFs can vary depending on the size and trading volume of the fund.

Regulatory risks: Changes in laws and regulations can negatively impact ETFs, such as restrictions on investments in certain countries or industries.

■ **Kindly tell us about some of the ETFs offered by your fund house.**

We have a slew of passive funds, namely the Tata S&P BSE Sensex Index Fund, the Tata Nifty 50 Index Fund, the Tata Nifty 50 Exchange Traded Fund, the Tata Nifty Private Bank Exchange Traded Fund, Tata Nifty Midcap 150 Momentum 50 Index Fund, and Tata Nifty India Digital ETF and Fund of Fund, and four debt passives in the target maturity space.

■ **How do you describe their performances?**

We have been very encouraged by their performance. Apart from doing the plain indexes like the S&P BSE Sensex and Nifty 50, we have also launched some products that are differentiated, like digital and midcap momentum. They are slowly

gaining traction. Our target maturity funds have seen reasonable size within a short period since launch, and we now have an AUM of about ₹2,222 cr, as on April 24, 2023, amongst them.

■ **What is your outlook on ETFs in the medium and long term and what would be your advice to potential investors?**

We remain selective in taking risks as macro factors continue to drive sentiment. From a domestic angle, the two most important factors that may drive the next leg of movement are Rain & Inflation. Though we are seeing initial signs of cooling off in inflation with RBI holding its rate hike cycle for now. However, the noise of El Nino is heard across the country and can lead to erratic rains, which in turn may spike inflation again. We are in a wait-and-watch mode with more of bottom approach selection as market valuations are reasonable and near the long-term average. We advocate a near-term focus on resilience via quality stocks and would advocate investments in Balanced Funds at this juncture.

■ **What lessons can the Indian ETF segment draw from the experiences of western markets in terms of market penetration and creating awareness among investors about this product?**

The penetration of ETFs among retail investors remains low. For example, the majority of equity fund AUM is contributed by individual investors (retail and HNI), but in the case of ETFs, it is in the single digit. Investor education is critical for the growth of this product.

■ **What is your verdict as far as ETFs are concerned?**

ETFs are an excellent product for investments with low fees. They are a well-diversified product trying to mirror the underlying index with no emotional bias of the fund manager. ■

Disclaimer: The views are personal. This is for information purpose only and should not be construed as investment recommendation.

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