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Should you invest in exchange-traded funds?

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MUMBAI: Finance minister Arun Jaitley in the Union budget announced that exchange-traded funds (ETF) will be used as a vehicle for stake sales in state-run companies.

The announcement follows the success of the second tranche of the CPSE ETF, launched last month by Reliance Nippon Asset Management Co. Ltd. The original CPSE ETF was launched in 2014. But what is an ETF and how does it help you?

If you want to invest in equity through mutual funds, you have the option of choosing actively managed funds or passive funds. Active funds are those where a fund manager decides which stocks to include and which to leave out of the portfolio. Passive funds, on the other hand, don't have fund managers deciding the portfolio. Rather, the stocks are selected according to a chosen index. An ETF is a type of passive fund where the portfolio mirrors an index of stocks and the proportions they are held in. The first CPSE ETF, for example, is linked to the 10 stock Nifty CPSE index, which includes state-run companies where the government has been disinvesting. Investors should choose passive funds based on their requirements and preferences. Here are some reasons why passive funds such as ETFs may suit your investment needs.

LONG-TERM INVESTOR

If you want to remain invested in equity assets for 5-10 years or more, ETFs can serve as a good platform. Over very long periods of time, it is the allocation to the asset class that matters more than specific funds. You can buy the desired ETF, for which you need to choose the appropriate index. ETFs could be designed around overall diversified market indices or even specific sector indices. Thus, even with ETFs, you can choose where you want to be invested. However, keep in mind that investing in sector specific ETFs will be riskier than a broad market ETF and it's not a strategy that first-time investors should adopt.

LOOKING FOR LOW-COST INVESTMENTS

Domestic, actively managed equity funds have expenses of anywhere between 2.25-2.5%, whereas their ETF counterparts have expenses of around 0.3-0.5% on average, and some also have expenses as low as 0.05%. If you want to benefit from equity returns at a very low cost, then ETFs are a good choice.

INABILITY TO SELECT FUND MANAGERS

Investing in active funds requires you to choose between various types of funds and fund managers. The performance of the fund also reflects the skill of the fund manager. Thus, the long-term performance of your scheme isn't just dependent on how the equity market does over any period of time, but also on the skill of the fund manager. You have to be reasonably sure to pick the better-performing funds and ensure that you monitor the performance periodically. Moreover, fund managers often move from one asset management company to another.