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Smart-index ETFs good for passive investors

While the initial 'smart' index is based on quantitative models, the fund manager has no role to play after that. Being ETFs, they are cheaper as well

SANJAY KUMAR SINGH

Sundeep Sikka, chief executive officer, Reliance Nippon Life Asset Management, believes that one of the main reasons investors should buy passive funds is the massive cost difference of about 150-200 basis points vis-a-vis actively-managed funds. "And for a relatively-low cost, passive funds allow investors to earn broader market returns," adds Sikka.

Obviously, many fund houses are looking aggressively at this segment to attract investors. Edelweiss Asset Management recently launched Edelweiss ETF-Nifty Quality 30. This exchange-traded fund (ETF) is based on the concept of smart indices. Reliance and Kotak AMC already have ETFs based on these indices. The launch of these ETFs is an interesting development in the evolution of passive investing in India.

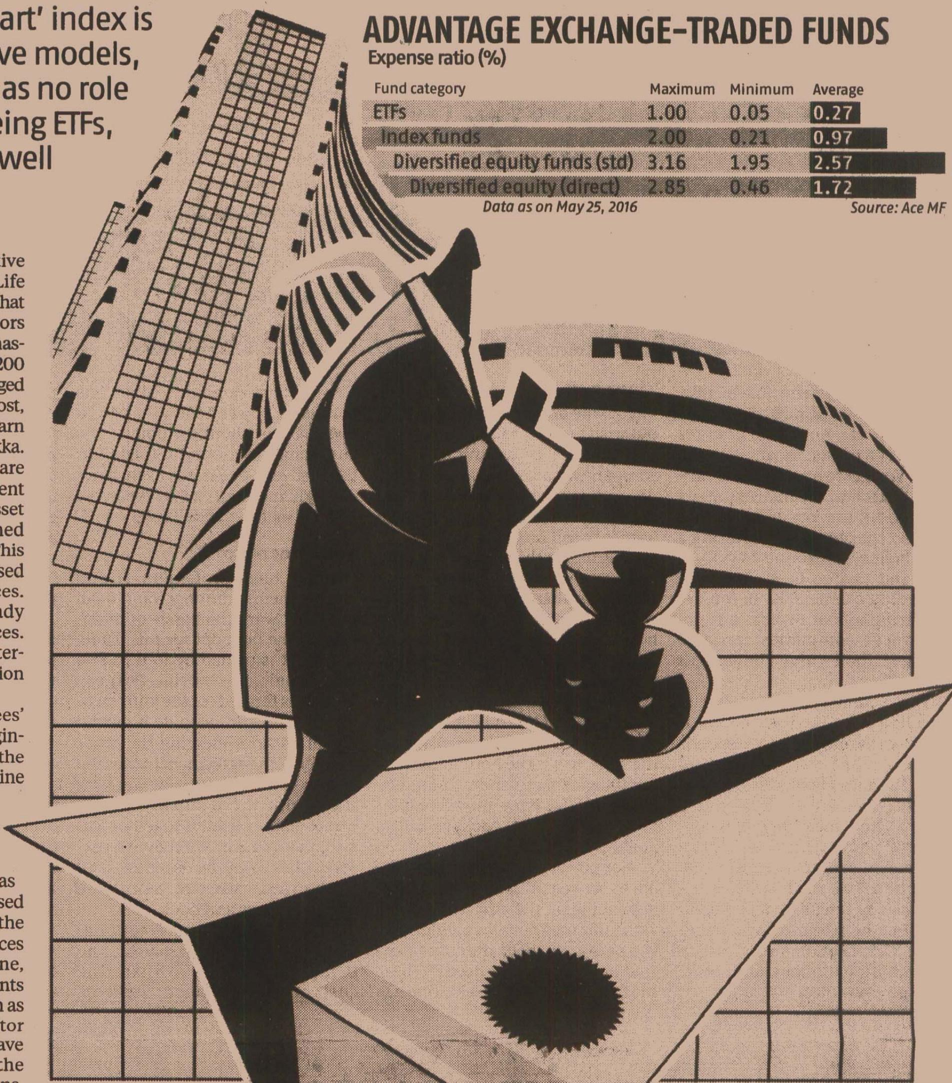
In fact, with the Employees' Provident Fund Organisation beginning to invest in equities through the ETF route, a more robust product line may be in the offing.

ADVANTAGE EXCHANGE-TRADED FUNDS

Expense ratio (%)

Fund category	Maximum	Minimum	Average
ETFs	1.00	0.05	0.27
Index funds	2.00	0.21	0.97
Diversified equity funds (std)	3.16	1.95	2.57
Diversified equity (direct)	2.85	0.46	1.72

Data as on May 25, 2016 Source: Ace MF



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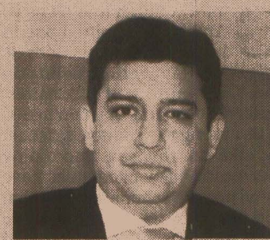

SUNDEEP SIKKA

Chief executive officer, Reliance Nippon Life Asset Management

Strategy index-based ETFs have the capability to create alpha over a plain vanilla ETF based on a broad market index like Nifty or Sensex. These ETFs are launched after extensive back-testing of performance. They are well-suited for savvy investors

MUKESH AGARWAL

Chief executive officer, IISL

One index can beat all others perpetually. The performance of an index-based fund, including a strategy index ETF, will depend on the stage of the market cycle

Smart ETFs are better than broad-based index funds

The passive fund space in India has been dominated so far by ETFs based on broad market indices, such as the Nifty and the Sensex. These indices have a couple of drawbacks. One, there are times when large segments of the market underperform, such as the commodity and public sector space in the recent past. If these have a considerable weightage in the index, they drag down the returns, affecting the performance of ETFs based on these. "Just by excluding the underperforming stocks from their portfolios, fund managers can easily beat a broad index like the Nifty," says Manas Shukla–head ETFs, Edelweiss Asset Management.

Another issue with market cap based indices is that they give higher weightage to stocks with higher market capitalisation. "Having already attained such a large size, it will be difficult for most of these stocks to achieve high growth in the future," says Deepak R Gupta, equity fund manager, Kotak Mahindra Asset Management Company (AMC). Their growth rates will at best be steady and sedate. The slow growth in turn affects the returns of these indices.

Smart indices (they go by various names—strategy indices, factor-based indices and also smart-beta indices) have been developed by index providers to overcome these shortcomings of market cap-based indices. Basically, the index developer picks up an investment strategy used by an active fund manager, such as value, quality, momentum, dividend yield, etc, develops quantitative criteria around these, and uses those to pick up stocks that constitute the index. "Strategy indices attempt to capture specific areas that are part of the broader markets and create differentiated returns," says Sikka. Perhaps you are familiar with the concept of stock screens or stock filters. What does a money manager do there? He begins with a large set of stocks (such as the BSE 500), applies quantitative filters, and obtains a smaller set that meets the criteria. He does additional qualitative research (which takes a lot of time) on the stocks thrown up by the screen, and finally invests in those that appear the best bets.

In this case of smart indices, a set of quantitative criteria is similarly applied to select stocks and develop an index. Any room for further selection and discretion doesn't exist thereafter. While selection, as happens in active funds, can lead to outperformance, poor selection can lead to underperformance. What you get here is a diversified basket of stocks that meet certain investment criteria (quality, value, etc,). Index providers back-test the index and if they find it can provide market-beating returns over the long term, they offer the idea to a fund house, which in turn launches an ETF based on it. The low expense ratio of these ETFs also assists their returns.

Not too many choices

Besides Edelweiss Mutual Fund's Nifty Quality 30 ETF which uses criteria like high return-on-equity, low debt-to-equity ratio, and rising year-on-year profit after tax to select 30 stocks.

Reliance and Kotak AMC have ETFs based on the Nifty Value (NV) 20 Index. This index uses criteria like low price-to-earnings ratio, low price-to-book value, high return-on-capital-employed (RoCE), high dividend yield and a track record of regular dividend payment to pick stocks. Reliance AMC also offers an ETF based on the dividend opportunities strategy which invests in stocks having high dividend yields.

Lack of human intervention can be risky

Smart-index based ETFs are no doubt more intelligent products than market cap, based indices. They use some of the same filtering criteria an active fund manager does. At the same time, by not allowing any human selection, they take away the scope for playing around with a strategy (as active fund managers sometimes do) in years when it does not seem to be working. And, they do have a couple of weaknesses.

First, as Mukesh Agarwal, chief executive officer (CEO), IISL, the NSE subsidiary that provides the majority (around 80 per cent by AUM) of the indices on which ETFs in India are based, says: "No investment strategy works in all market conditions." Strategies like quality and value tend to do better when market conditions are bearish or volatile. But, they could lag the broader market during bullish conditions. Since an ETF requires you, the investor, to put money into the market regularly, and is not based on an automated process like an SIP (systematic investment process), you must have the discipline to keep investing even when market conditions are adverse and the ETF you have invested in is lagging a broader index such as the Nifty.

Second, these ETFs are still new in the market and don't have much of a track record. They have been launched on back-tested data. Obviously, AMCs launch their products in market conditions when past results are good. How they perform across market cycles in actual conditions remains to be seen.

What should investors do?

Passive investing is a good idea in itself. It is true that the majority of active funds in India outperform the broad market. The average annual equity mutual fund performance over the past 10 years has been 11.09 per cent compounded, against the Sensex return of 8.4 per cent, which is an alpha of 2.6 percentage points after adjusting for expenses, according to the CRISIL AMFI Equity Fund Performance Index of March 31, 2016. However, predicting and picking funds which will outperform in the future is nearly impossible. Also, the set of active funds that outperforms keeps changing. So, even if you pick a five-star or a four-star fund today, there is no guarantee that it will remain an outperformer over the next 10-20 years. "With passive funds, you don't have to chop and change funds and can easily earn market-equivalent returns," says Ankur Kapur, founder, Ankur Kapur Advisory. The declining cost of ETFs (*see table*) is a positive development that will help them to further close the performance gap vis-à-vis active funds. In the large-cap space especially, which is heavily researched, outperforming the index will become more and more difficult as time goes by and there you may well adopt a passive strategy.

With institutional money coming into the markets, ETFs will gain further prominence. The Employees' Provident Fund Organisation (EPFO) is mandated to invest 5-15 per cent in equities and has chosen to invest 5 per cent to begin with, through index ETFs. So far it has invested about ₹6,600 crore.

Strategic index-based ETFs are an innovation. They have gathered a lot of money in the global markets in the past couple of years. Choose an index whose investment strategy you agree with. For instance, if you believe that the value strategy works across market cycles, invest in that ETF. It will be easier to stick to it in conditions when the strategy is not working. Begin in a small way and increase your exposure as you gain confidence.