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It's Time Investors Actively Participate in ETFs

Expert Take

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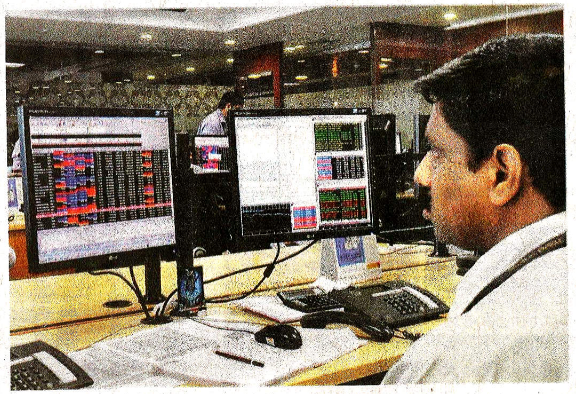
Recent regulatory actions have forced India's mutual fund houses to re-classify their existing schemes. The sole motto of the new guidelines is basically to rationalise the plethora of schemes, which, at times, were quite confusing for investors. This, often, led to poor investment decisions, and even mis-selling of mutual funds schemes.

In the wake of re-classification, large-cap schemes are likely to lose weight when it comes to creating wealth for investors. These schemes, as the category suggests, invest in top companies which are usually part of the benchmark indices of the Indian stock market indices—the Sensex and the Nifty 50. However, if one looks at the return of the large-cap category over the past decade, one finds that vis-a-vis their benchmarks, the category has continuously failed to beat the benchmark with a wide margin.

DISMAL SHOW BY LARGE-CAP FUNDS

For instance, in the past year, the category average return of large cap schemes stood at 11.02% as on July 2, 2018. The return of Nifty 50 index was higher at 11.87%. Similarly, in the past 10 years, large-cap schemes generated a return of 11.07%, while Nifty50 index returned 10.58%. The alpha return, thus generated, is merely 49 basis points—that too in the span of 10 long years. This is not only disappointing, but also an injustice to investors' hard-earned money. And what is more concerning is the fact that all this happened at a time when the current new guidelines of re-classification were not in force and fund managers were free to construct the scheme's portfolios by cherry-picking stocks. After reclassification, the performance has further slipped. Till July 13, 2018, large-cap funds on an average recorded a return of 1.11%, compared to 1.92% of the NSE 100 ETF and 3.73% of the BSE Sensex ETF. Since the beginning of the year, the performance of large-cap funds is even more dismal. Between December 31, 2017 and July 13, 2018, large-cap funds on an average gained less than 1% at 0.68%, compared to 3.59% of the Nifty 100 ETF and 8.84% of the BSE Sensex ETF.

We must remember that the sole objective of the fund manager is to generate risk-adjusted higher alpha return (or benchmark beating returns) for the investors. But that doesn't seem to be happening.



SMART INVESTORS are fast realising the power, importance and effectiveness of ETFs over the plain vanilla large-cap funds

Now the question arises is whether large-cap funds are worth investing going forward? If they are not, what alternative an investor has if she wants to reap the benefit of stock markets by being in large-cap stocks?

It is here that one needs to know and understand exchange-traded funds (ETF). Given the current status of large-cap schemes' performance and expected scenario going forward on the back of fund managers' commentaries and regulatory actions, ETFs look quite a preferable option compared with large-cap funds.

ETFs VERSUS LARGE-CAP MUTUAL FUND

The returns from ETFs may either be on a par with large-cap schemes or better as has been seen in recent years. Second, ETFs would be much cost-efficient as fees in ETFs could be as low as 0.01% while fees for large-cap mutual fund scheme can be anywhere between 1.5% and 2.5%. Such a huge differential in fees can really make ETFs far superior as higher expense fees of large-cap funds tend to impact the returns in investors' hands. Third, the net asset values (NAV) of large-cap schemes, like any other mutual fund schemes, are calculated after the closing of market hours, thus investors get a certain price every day. However, in case of an ETF the price changes throughout the day and investors get several price levels of entry or exit points and thus are not limited by the post market hours NAVs. The other reason to avoid large-cap funds would be the high churn in the schemes.

India already has started showing signs of significant rise in ETF activities. In the past two years, ETF assets (barring gold ETFs) has improved from 1% of the total mutual fund assets to 4%. In absolute terms, the size has grown from ₹177.43 billion in May 2016 to ₹812.72 billion in May 2018. This is an indication that smart investors are fast realising the power, importance and effectiveness of ETFs over the plain vanilla large-cap funds. Currently, the ratio has reached over 25%.

According to global experts, ETF assets will double to $10 trillion by 2022 from the current $5 trillion. ETFs are the future. As the market matures and alpha generation becomes difficult, it will become tough for fund manager to beat the benchmark or index.

Therefore, it will be in investors' interest to recognise the potential of ETFs well in advance and seriously take it as a strong alternative to large-cap funds.

(Author is executive director at Reliance Securities)