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Passive investing – current scenario

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In the developed countries, Mutual Fund (MF) Assets under Management (AUM) has raced past bank deposits. The scenario in India is quite different where MF AUM is slightly above one-fifth of the bank deposits. Investing could be in the form of **Active** investment where a Fund Manager actively manages the portfolio of a MF Scheme or Portfolio Management Scheme (PMS). Other form of investments is **Passive** investment where services of Fund Manager are required just for re-balancing the portfolio in the same composition as that of a market index, which is dynamic in nature.

Though **passive investing v**iz. index funds, ETFs, FoFs, etc. in India constitutes just around 9% amounting to Rs 2.72 lakh crore of the average MF AUM of Rs 32.17 lakh crore as on 31st March 2021, yet it has witnessed annualised growth of 142% in last 2 years.

US SCENARIO

Passive investing is made up of funds tracking market indices where human intervention is hardly required. In the United States, it has now reached nearly half-way mark of the stock market capitalisation as more & more investors shun stock-pickers and move towards index funds. Market share for passively managed equity and debt funds has risen to almost 50%, up 400 basis points from June 2018, according to data released by Bank of America Merrill Lynch. That follows a trend over the past decade in which investors have taken keen interest in indexing, particularly through exchange-traded funds (ETFs).

About 10 years back, active investment had a nearly 3 to 1 ratio over passive investment in U.S. equity funds, according to Morningstar. That gap began to dwindle significantly in 2012 and has come down sharply when one looks at present position.

Dr Micheal Burry, the man who predicted/anticipated global financial crisis says, the next stock market crisis is likely to be due to passive investment vehicles like Index ETFs. The liquidity is propping up all stocks irrespective of their fundamentals and earnings growth. He has compared growing stock and bond prices did with collateralised debt obligations did for subprime mortgages more than 12 years ago. Like most bubbles, the longer it goes on, the worse the crash will be. In nutshell, incessant funds inflow in passive funds have swelled the index so much that they are far ahead of their fundamentals in years.

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STATUS IN INDIA

In India, passive funds just mimic the portfolio allocation of the benchmark index, and Fund manager must keep rebalancing the portfolio, so as to keep it aligned to the benchmark index. Since there are no skills required in managing such passive funds, no stock-investment calls are required to be taken, thereby reducing the cost for investors that, in turn, enhances the return for the investors.

In a market scenario, where majority of actively managed funds are finding it difficult to beat their respective benchmarks (barring last 5 months when incessant FPI funds inflows have changed the active investment scenario), investors are flocking to the passively managed funds and we see Fund Houses launching more of passively managed funds. This shift of investors could be attributed to SEBI re-classification of large cap, midcap and small cap categories, linking Total Expense Ratio (TER) to the corpus of the MF scheme, Indian equity markets maturing and enhanced coverage of equities.

EXCHANGE TRADED FUNDS

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Other than passively managed Index funds, Exchange Traded Funds (ETFs) are also passively managed funds with low expense ratios. Since ETFs are traded on the Stock Exchanges, the unit price keeps changing like an equity share throughout the trading session, albeit, with a lower volatility.

NAVs of the index funds change only at the end of the day. The only distinction is mandatory requirement of demat account for ETF unlike index fund where it is optional. ETFs could have a problem of liquidity, as trading depends on the demand and supply whereas MF units could be bought back by the Fund Houses when redeemed, thereby posing no problem as far as liquidity is concerned.

GoI INITIATIVES

Government of India (GoI) commenced encouraging investments in ETFs by launching first equity CPSE ETF in March 2014 whereby units were offered at a discount to retail investors. The CPSE ETFs FFO series 1 to series 6 evoked good responses from investors as subscription always exceeded the issue size. Subsequently, GoI launched first debt Bharat ETF in December 2019 followed by second tranche in July 2020. The Bharat Bond ETF does not carry much credit risk as it invests only in AAA-rated state-owned corporations.

When investing in ETFs through a Systematic Investment Plan (SIP), one must pre-determine number of units, not amount, as units have to be purchased in round figure like equity shares. This facility of systematic investment in ETFs is available on select online trading platforms. Investing in passive funds makes sense in today's scenario when majority of actively managed funds are not beating benchmark indices, therefore dis-incentivising payment of a higher fee for an actively managed fund. Hence, there is a need to increase the weight of passive funds in one's portfolio in Indian markets.

GLOBAL SCENARIO

The inclination towards passive investing through index funds and exchange-traded funds (ETFs) has witnessed substantial growth over the years, substituting higher cost active investment trend. A migration towards passive investment could affect securities market in two major ways.

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First, passive investing could establish higher correlation with returns and lesser stock-specific price information. Secondly, it could impact total investment inflows and alter market price dynamics. Since actively managed funds are finding it increasingly difficult to beat benchmark indices, there has been consistent outflows in the recent past, whereas passive funds' corpus has remained stable.

Across globe, passive funds have increased their allocation to US equities, Japanese Government Pension fund's enhanced allocation towards equities, aptly supported by the Central bank's ETF purchases. Similar trend has been witnessed in the rising proportion of passive funds in European as well as emerging markets.

The investors' choice of investment vehicle depends not only on the track record of the fund manager but also on their own investment style preferences coupled with risk appetite. In principle, investors could earn better returns by identifying the active funds which are outperforming indices**.**

ACTIVE vs PASSIVE INVESTING

Proponents of active investing term passive investing as limited, with hardly any flexibility, which keeps the investors to latch on to those holdings irrespective of what is happening to the financial markets.

> *The recent shift of low-cost passive funds has been supported by artificial intelligence in the financial advisory industry.*

By definition, passive funds would never beat the benchmark, even during tumultuous times when their core holdings are locked in to track the benchmark index. Active funds could get you higher rewards but those come with higher risk.

The recent shift of low-cost passive funds has been supported by artificial intelligence in the financial advisory industry. These include, emergence of robo advisors, fiduciary duty requirements, and moving away from upfront incentives. Regulators have focused on bringing transparency for the investors irrespective of active or passive form of investing.

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CONCLUSION

There has been a rapid growth trend, albeit on lower AUM base, over the past decade of ‘Passive Investing’ in India. The primary factor attributed to more than quadruple rise in passive investing is the inability of active Fund Managers to beat bench-mark indices in the last couple of years.

November 2020 onwards, we have witnessed massive inflow of FPI funds in equity markets where we noticed some of the MF schemes managing to beat bench-mark indices, however, majority of MF schemes lagged the bench-mark indices. Government of India has aided in promotion of CPSE equity and Bharat bond ETFs by offering NAV discount to the retail category of investors (Maximum of Rs 2 lakh investment). Besides Index funds, those are managed passively having low expense ratio, Exchange Traded Funds (ETFs) also fall under the same category with a lower expense ratio. MF scheme NAVs are not dynamic in nature. This is because investments can be done only at the day-end NAV. However, ETFs are traded on the Stock Exchanges, and the ETF unit price keeps changing like an equity share throughout the trading session, albeit, with a lower volatility as it consists of basket of securities.

Apart from its benefits, Passive Investing also brings in its own set of challenges as they are purely driven by market forces, where there is no chance of outperformance, unlike active MF schemes where Fund Manager could take a decision on entering or exiting a stock. Another challenge in passive investing is that the the investors lack choice as index composition is static in nature.

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