GO PASSIVE
PASSIVE INVESTING CONCLAVE 2021

Finity

Passive Investing Report
2021

Driving the next wave of growth in Indian markets

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Contents

Foreword

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The rise of mutual funds in India has been a well-documented story, thanks to successful campaigns such as 'Mutual Funds Sahi Hai' and 'Jan Nivesh'. Over the past three decades, mutual funds have been great wealth creators for investors while also playing a sterling role as custodians of investors' money.

The past decade has been especially one of growth for mutual funds, with assets growing 5.5 times. And within this, there lies another success story - that of passive investing.

Over the past several decades, globally, a visible trend has been the disappearance of alpha, or active mutual funds' ability to derive excess returns over the benchmark index. The trend appears to have caught up with India, sparking a rising interest in passive investment products such as index funds and ETFs.

In the previous financial year, customer account folios in passive assets have more than doubled. And yet, this growth is minuscule when compared to how passive assets have grown globally.

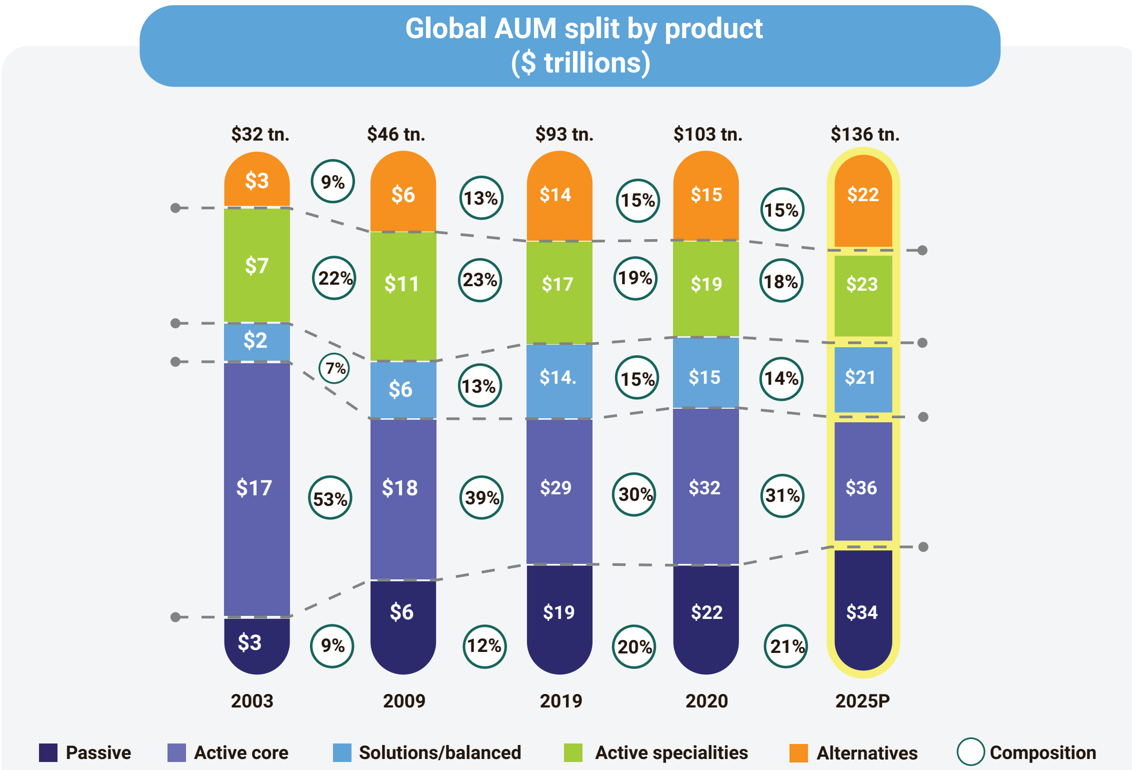
At Finity, our overarching tenet is to democratize financial services and provide the best possible advice to investors. The following are part of our efforts towards the same.

- We are launching our first report on passive investing - ***'Passive investing report 2021 - Driving the next wave of growth in Indian markets'.*** Our endeavor with this report is to provide a holistic view of passive investing in India and in global markets, analyze important trends, and provide a glimpse into the future of passive investing. We hope that through this report both the investors and the investing community at large will learn more about passive investing.

- We are organising ***'GoPassive Conclave - 2021'***, India's first passive investing conclave that will bring together industry veterans to talk about the future of passive investing. This conclave will be conducted on October 22, 2021, and will be hosted on Finity's website and social media handles.

01 Executive Summary

The asset management industry emerged in a position of strength from the global pandemic last year. In 2020, the industry crossed the monumental milestone of $100 trillion in Assets Under Management (AUM). Overall, global assets in the asset management industry grew by 11% in 2020 to end the year at $103 trillion of AUM. Despite the economic challenges, uncertainty, and the initial shock that the pandemic caused, globally markets bounced back with healthy returns.



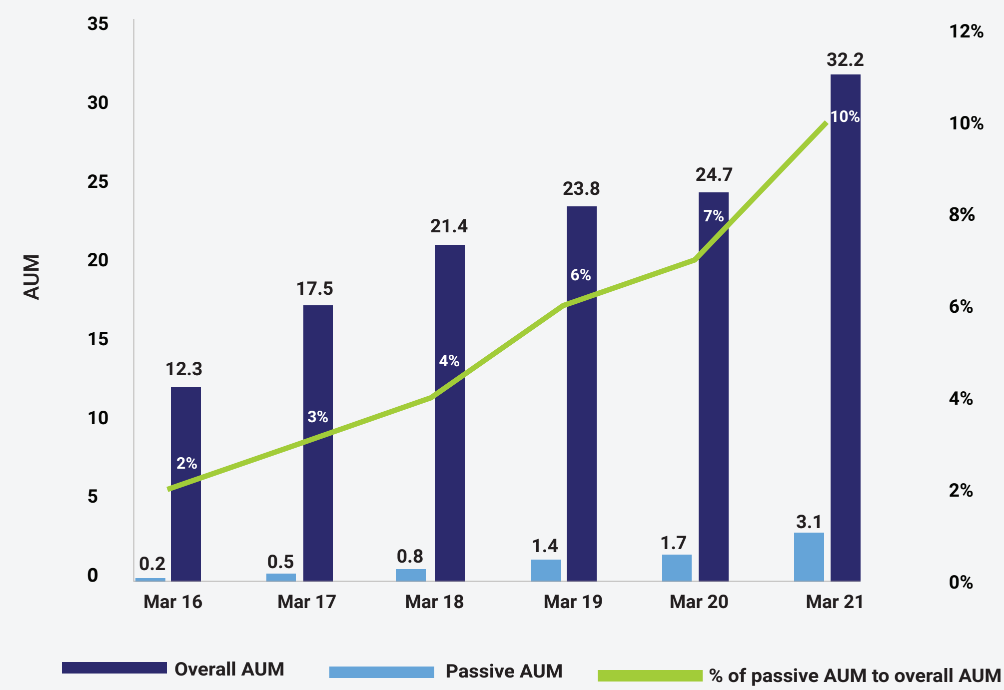
Source : BCG Report
Calendar year

- Passive products recorded their highest growth in the pandemic-affected year. Passive AUM rose by 17% globally during 2020 with strong net inflows and market growth.
- BCG forecasts passive investments to be the fastest-growing asset class over the next five years.

The trend of the shift of assets from active to passive management seen over the past decade has started showing up strongly in India. Passive assets, customer folio accounts in passive assets, passive products (ETFs & Index), and passive assets as a percentage of overall assets have more than doubled in the previous five years.

At the end of March 2021, the size of the Indian mutual fund industry was ₹ 32.17 trillion (approximately $ 416 billion), of which about 10% of assets were in passively managed products.

Growth of Indian mutual funds and passive assets (₹ trillions)



Source : AMFI
Financial year

The rise of passive assets in developed markets such as the US was mainly due to three factors; namely, the underperformance of active funds compared to benchmarks, the lower cost of passive funds as compared to active funds (expense ratio), and the conducive regulations and policies in the US for passive investments.

In India, too, similar trends have been witnessed in the recent past. The three factors that have contributed to rising interest in passive investing in India are:

- **Underperformance of active funds**: Over 80% of the funds in the equity large-cap category have underperformed the benchmark over one, three, and five-year periods as of June 30, 2021. *(Source: SPIVA)*

- **Cost:** The average expense ratio of large-cap funds in India is ~1.5%. Passive products tend to be in the range of 0.05% to 0.3%. This difference may seem insignificant, but over a long period, these costs add up. The cost of funds is considered a significant factor in value creation over the long term.

- **Regulatory and government policies:** Initiatives such as benchmarking to total return indexes, the government's disinvestment drive through ETF, EPFO (Employees' provident fund organization) investing in equities through large-cap ETFs, and recent approval to launch silver exchange-traded funds have acted as a significant catalyst in the growth of the overall mutual fund base and penetration of passive funds.

We expect that passive and active funds will play complementary roles in most investors' portfolios as part of the asset allocation strategy. However, passive funds will take center stage in portfolios of investors at large.

We estimate that passive assets will cross ₹ 25 trillion of AUM by 2025 from an AUM of ₹ 3 trillion in March 2021, which is a growth of more than 8X. We also estimate that passive assets will grow to constitute 37% of the overall assets in the mutual fund industry by 2025 from the 10% as of March 2021.

Note: *To track underperformance, we have used SPIVA (which stands for S&P indices versus active funds). The SPIVA report is used worldwide to compare the performance of active funds against S&P benchmarks in various markets.The SPIVA Scorecard has acted as the de facto scorekeeper in the active vs passive debate since its inception in 2002.*

02 What is Passive Investing?

Passive investing is broadly a buy-and-hold investment strategy where the investor invests in a basket of securities as defined by a set methodology based on an underlying index or predefined set of principles. A passive investing strategy does not require an investor to buy and sell actively. One of the most common methods of passive investing is index investing, where the funds track a particular underlying index.

The concept of passive investing as a strategy began several decades ago in the West. While in India it started gaining wider traction only in the last few years.

There are two main vehicles for passive investing i.e., Index funds and exchange-traded funds (ETFs).

Index funds work exactly like a traditional mutual fund scheme, except that the fund manager will buy and maintain the portfolio according to the index's composition.

An **ETF** is like a mutual fund, which holds a basket of securities. It is then converted into a single security that can be traded on the stock exchange.

In both cases, the product aims to replicate its respective underlying index by mimicking its stock weight. An index fund is usually offered by distributors and asset management companies. An ETF is listed on a stock exchange and can be purchased through a demat account.

Comparison between active and passive management styles

	Active management	Passive management
Objectives	Aims to outperform the market	Aims to generate almost equivalent returns of an index
Techniques	Active stock selection takes advantage of inefficiencies in the market.	Follows Efficient Market Hypothesis (EMH). It says the market is highly efficient, stock price movements have already been processed and acted upon. And so, beating the index is a difficult exercise.
Philosophy	Stock picking	Mimics the composition of an index
Decision Maker	The fund manager	The index

Pros and cons of active and passive investing

Active investing is based on the idea that investors can generate returns that are greater than that of market indexes through careful stock picking. The additional returns over that of the index is called 'alpha'. Passive investing philosophy goes by the idea that generating alpha is a difficult exercise, especially after adjusting for a higher cost (expense ratio).

Comparison between active and passive management styles

Active management

Pros	Cons
Potential alpha returns Opportunity to outperform the market	**Human error** Performance depends on the skill of the manager
Flexibility Active funds invest more freely than their passive counterparts as they are not tied to an index	**Higher costs** Higher management fees for the expertise and resources required for active management
Risk management Active managers can minimize potential losses by avoiding certain sectors, regions, market cycles, etc. Buy/sell decisions based on research	**Tax inefficient** Typically, less tax-efficient due to churning of stocks which attracts short term and long term capital gains tax

Passive management

Pros	Cons
Match market returns Likely to perform close to an index	**No additional alpha** Investing in the underlying index would mean additional returns are not possible
Low cost Management fees are usually lower than an actively managed fund	**Liquidity** Sometimes due to market news, passive funds mimicking their underlying index run the risk of liquidity i.e., challenges in buying or selling underlying stocks
Tax efficiency Follows buy-and-hold strategy. Does not typically result in higher capital gains tax for the year	**Lack of choice** Buy/sell decisions based on an index, not research

Key things to follow while investing in passive schemes:

- **Tracking difference** refers to the variance in performance between a passive (ETF/Index) fund and the underlying benchmark index tracked by the fund.

  Example: Suppose the BSE S&P Sensex index gained 10% this month and, on the other hand, the NAV of an index fund that tracks the Sensex gained 9% during the same period, this difference of 1% is the tracking difference of the passive fund.

- **Tracking error** is an indicator of the variability in the performance of the passive fund. It shows the consistency of a product's tracking difference during a specific period. Theoretically put, tracking error is the annualized standard deviation of the tracking difference of a passive fund.

- **Liquidity** is also an important factor to track especially while investing in sectoral/ thematic ETFs. As ETFs only trade on stock exchanges, investors would be able to sell/buy only if there is enough demand and supply.

03 How Passive Investing came to be?

John Bogle, the founder of Vanguard, pioneered passive investing for the masses. He showed how saving on fund expenses can make a huge difference to investors' returns.

A great visionary and a trendsetter, Bogle was intrigued by the path-breaking research published by Nobel laureate Paul Samuelson of the University of Chicago. Among Samuelson's several path-breaking insights, the one which has had the greatest impact on financial markets is the ***Efficient Market Hypothesis.***

Philosophy of EMH - Efficient Market Hypothesis

The efficient market hypothesis believes that when new information enters the market, it is immediately reflected in stock prices, and thus, neither technical nor fundamental analysis can generate alpha. In other words, this means that because stocks fully reflect all information, it would be impossible for any portfolio/fund manager to beat the underlying index.

The idea affirms that stocks will practically always sell for their true fair value on various stock market exchanges. Therefore the average investor would not be able to acquire undervalued stocks or sell them at excessively high prices. According to the efficient market hypothesis, the only way to outperform the markets is to acquire assets that carry a larger risk and offer bigger returns.

With the advent of mobile devices like smartphones, faster internet transmission, and quicker sharing of information on social media, new information becomes more rapidly and widely available making markets even more efficient than several decades ago.

The EMH philosophy struck a chord in Bogle's heart. He was amongst the first in the mutual fund industry to fully understand its profound implication.

Thus, was born Bogle's breakthrough idea. In 1976, Vanguard launched the world's first index mutual fund. Instead of attempting to beat the index and charging high fees, the index fund would mimic the index performance over the long run. Bogle's bet paid off for his investors. Over time, it became clear that a majority of active funds could not do better than the index fund. In 2000, the Vanguard index fund became the biggest in the world. It is now known as the Vanguard 500 Index Fund—one of the largest mutual funds in the world. As of August 2021, the fund had assets totaling almost $249.37 billion.

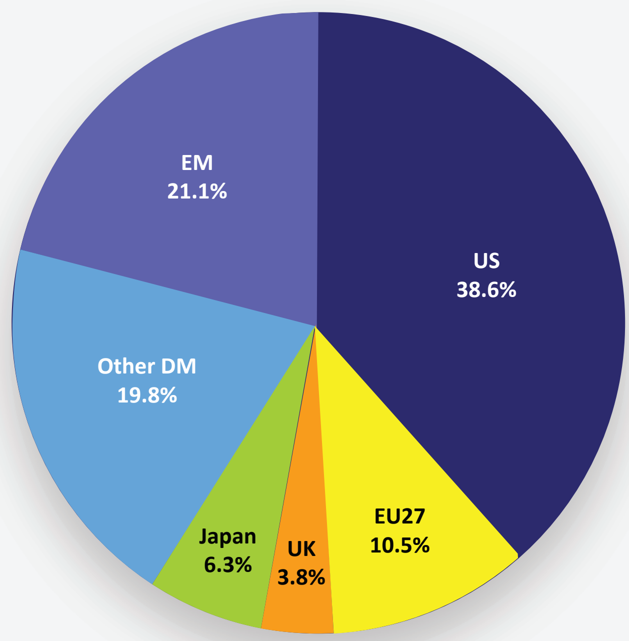
In 1993, a new instrument, ETF was created, which combined the benefit of an index fund with the ease of purchasing it like a share. The first-ever ETF, the SPDR S&P 500 Trust ETF, was launched in the United States. Even today, it is one of the most popular funds that aims to track the Standard & Poor's 500 Index, which comprises 500 large and mid-cap US stocks.

04 US capital markets and asset management industry

For decades, the US region has been the largest capital market and mutual fund market globally. The US market's relatively large size is due to several reasons, but mainly due to; one, mutual funds have been accessible to the investors in the US for almost a century now and two, creation of strong regulatory structure for securities markets and mutual funds.

US equity markets represent the largest capital market share i.e., 38.5% of the $105.8 trillion in global equity market cap, or $40.7 trillion as of December 2020. The size of the US equity markets is 3.7 times the next largest market, the European Union.

Global equity market cap 2020 ($105.8 trillion)

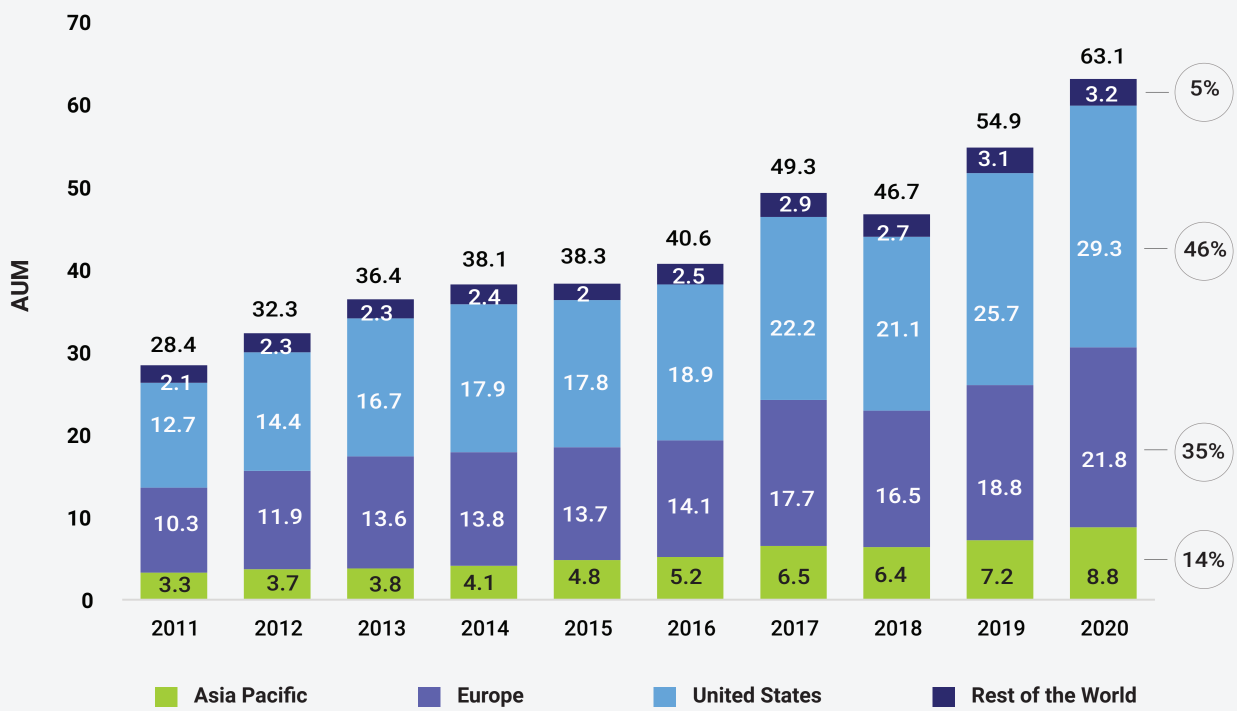


Note: For listed domestic companies; EM = emerging markets, DM = developed markets
EU27 : 27 European union countries
Source : World federation of exchanges, SIFMA estimates
Calendar year

US mutual fund industry

With $29.3 trillion in total net assets, the US mutual fund industry remained the largest in the world as of December 2020. At year-end 2020, a significant part of the total net assets in regulated mutual funds continued to be predominantly held in the United States at 46% of the worldwide total.

US has the largest share of total net assets of world wide regulated mutual funds ($ trillions)



Note : Regulated open-end funds include mutual funds, ETFs and institutional funds.
Source : International investment funds association
Calendar year

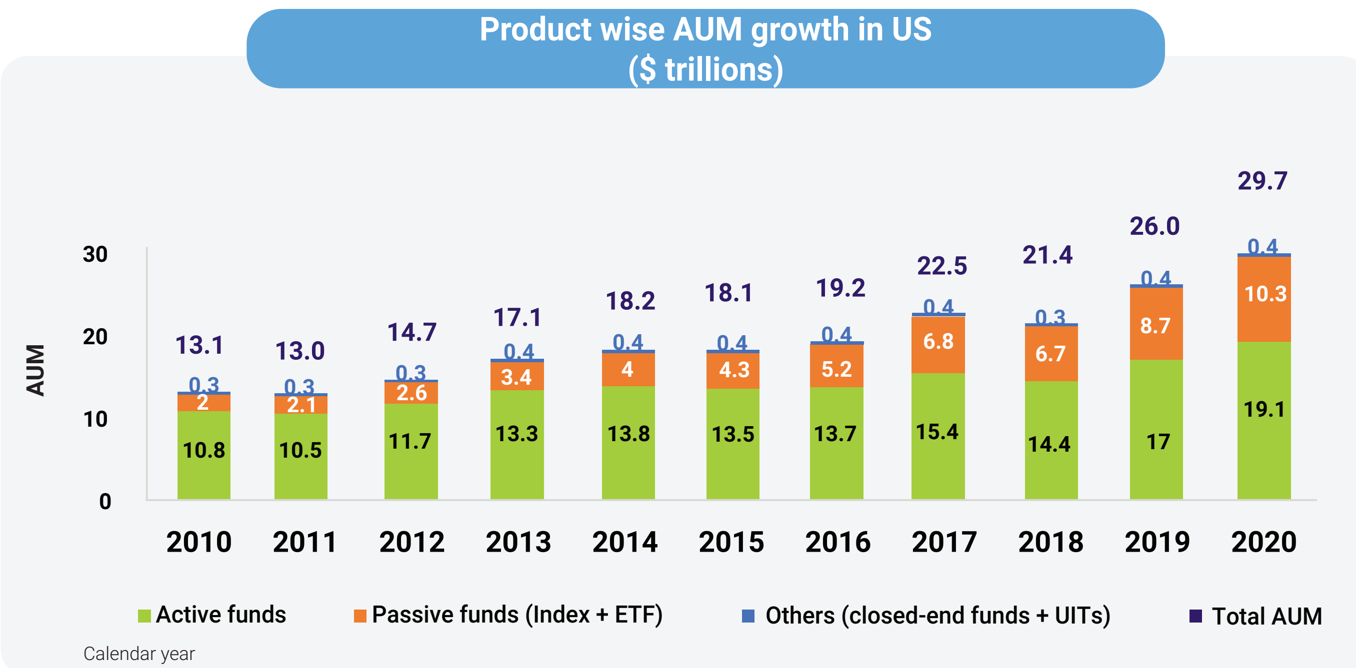
Breakout growth of passive assets in the US

While many investors had started looking favourably at passive investing as a strategy, it came into its own only after the global financial crisis of 2008. The large market fall in 2008 and the swift rebound in 2009 and 2010 caught many active fund managers off guard. As a result, a bulk of active mutual funds had started underperforming the benchmark.

The US mutual fund industry started gaining significant traction in passive products in 2010. The number of ETFs available in the US increased from 950 at year-end 2010 to 2,296 at year-end 2020. The number of index funds too grew from 365 at year-end 2010 to 490 at year-end 2020.

Assets under management

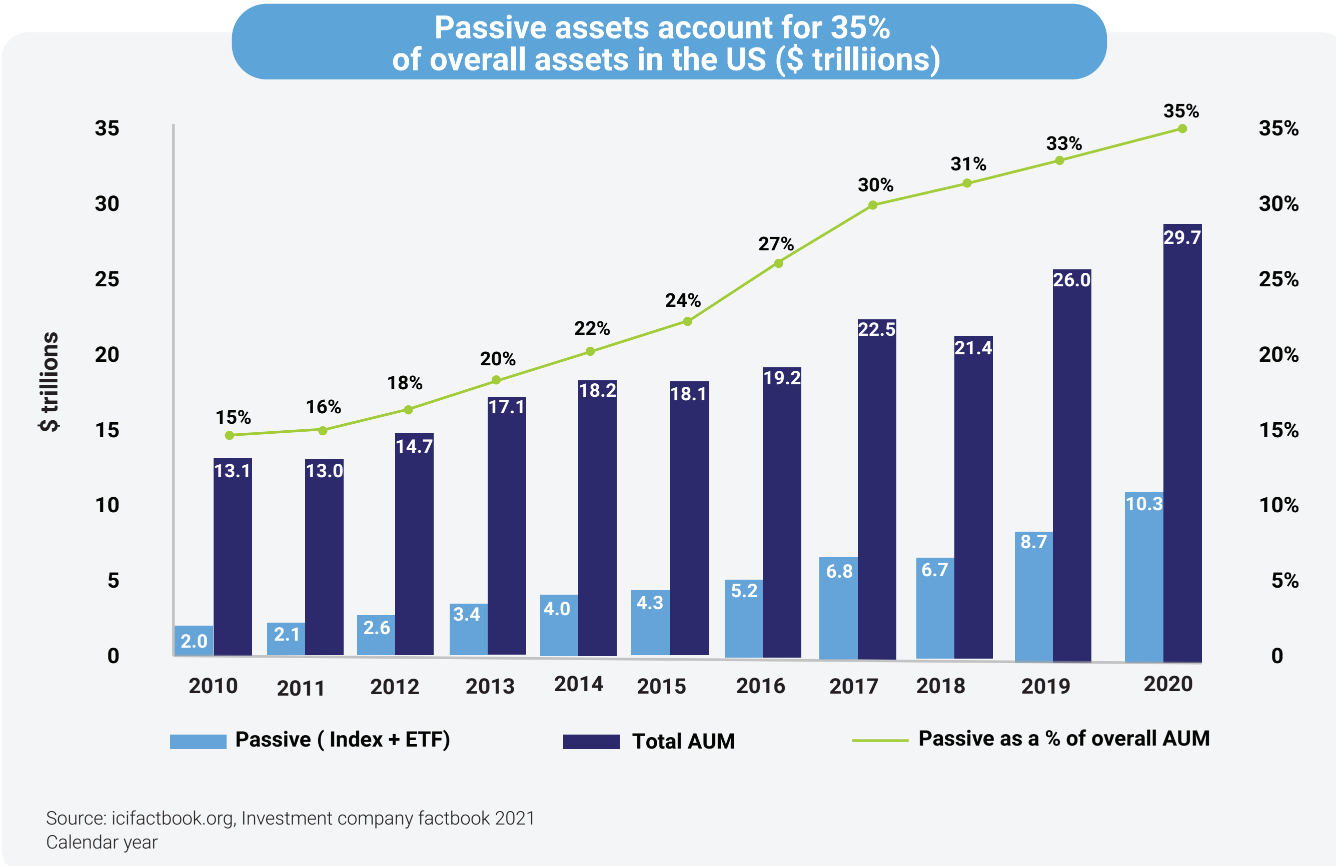
Since 2010, total assets in US registered investment companies have increased by 126%. But this growth has been led mainly by growth in passive assets. Below is the chart showing product-wise growth in assets.



Highlights

- The US asset management industry has a combined $29.3 trillion in assets.
- Growth of passive assets (ETFs & Index funds).
  - Index mutual funds have grown from $1,016 billion at year-end 2010 to $4,807 billion at year-end 2020. This is an absolute growth of 373% and a CAGR of 17%.
  - ETFs have grown from $992 billion in assets at year-end 2010 to $5,449 billion at year-end 2020. This is an absolute growth of 450% and a CAGR of 19%.
- In total, passive assets have grown from $2 trillion to $10.3 trillion in the last decade as of Dec 2020, which is an absolute growth of 410% and a CAGR of 18%.

In percentage terms, passive assets now account for around 35% of overall assets in the US.



Trends in US funds' performance

The unprecedented pandemic in the previous year infused fear and volatility across the world. But the world of capital markets began to recover in 2021 as the global economy resumed. The volatility in financial markets in 2020 gave plenty of opportunities for fund managers to demonstrate their stock-picking abilities.

The trend of active funds underperforming benchmarks is not a new one. As the below table shows, almost every year, a majority of funds underperform their benchmark indices. This trend becomes especially conspicuous during periods such as 2008/2009 (global financial crisis), 2015/16 (Chinese devaluation crisis), and 2020 (COVID-19 crash).

Note: *To track underperformance, we have used SPIVA (which stands for S&P indices versus active funds). The SPIVA report is used worldwide to compare the performance of active funds against S&P benchmarks in various markets. The SPIVA Scorecard has acted as the de facto scorekeeper in the active vs passive debate since its inception in 2002.*

Percentage of U.S. equity funds underperforming their benchmarks

Fund category	Comparison index	1 year (%)	3 year (%)	5 year (%)	10 year (%)	20 year (%)
All domestic funds	S&P composite 1500	43.7	71.5	71.5	85.9	87.8
All large-cap funds	S&P 500	58.2	67.6	72.6	82.5	93.8
All mid-cap funds	S&P midcap 400	75.5	49.3	59.2	73.0	90.7
All small-cap funds	S&P smallcap 600	78.0	54.8	66.7	83.5	93.8
All multi-Cap funds	S&P composite 1500	50.5	68.6	69.8	88.5	91.3

Source: SPIVA, S&P Dow Jones Indices LLC. Data as of June 30, 2020.
Returns shown are annualized. Past performance is no guarantee of future

Highlights

- The S&P 500 had recovered all of its COVID-19-related losses by August 2020, and it posted a 40.8% gain over the 12 months ending on June 30, 2021.
- 58% of large-cap funds, 76% of mid-cap funds, and 78% of small-cap funds underperformed the S&P 500, S&P Midcap 400, and S&P SmallCap 600, respectively, over the 12 months ending on June 30, 2021.
- More than 70% of all the US domestic equity funds underperformed their benchmark in the long run i.e. 3, 5, 10, and 20-year time frames.
- The trend gets worse when looked at from a long-term perspective. A majority of all large, mid, small and multi-cap funds have underperformed benchmarks over each of the past 5, 10, and 20-year periods.

There are largely 3 factors that are driving the exponential growth of passive assets in the US.

First, the majority of actively managed funds continue to underperform the respective benchmark Index.

Second, fees are a significant factor in the active vs passive argument. After fees, returns of actively managed funds are often lower than passively managed funds, as the latter is less expensive.

Third, robust regulatory framework and policies - The United States is home to the world's largest regulated mutual fund industry. The Securities Act of 1933 and the Investment Company Act of 1940 provide a strong regulatory framework for securities markets and regulated mutual funds in the United States.

For example, under the SEC's liquidity rule, illiquid assets cannot account for more than 15% of a mutual fund or ETF portfolio.

On the back of a sound framework, investor confidence in securities markets and regulated funds led to steady growth in US-regulated mutual funds' assets.

Passive assets, especially ETFs, have been fueled by the availability of regulated mutual funds as an investment option in tax advantage accounts *(for example, 401(k) plans)*, and by a broad and growing availability of fund types that help investors meet their investment goals.

05

Indian mutual fund industry

Over the last few years, the Indian mutual fund industry has grown by leaps and bounds. The industry assets have recorded more than 20% CAGR for the previous 5 years, from ₹ 12.3 trillion in March 2016 to ₹ 32.1 trillion in March 2021.

The industry's AUM had crossed the milestone of ₹ 10 trillion for the first time in May 2014 and in a short span of about three years, the AUM size had increased more than two folds and crossed ₹ 20 trillion for the first time in August 2017. The AUM size crossed ₹ 30 trillion for the first time in November 2020. The industry AUM stood at ₹ 37.4 trillion as of September 31, 2021

The genesis of passive investing in India

In 2001, then known as, Benchmark mutual fund launched the first Nifty ETF. Benchmark also launched the first debt exchange traded fund in 2004, called Liquid BeEs. This was the first money market ETF in the world. Later, Benchmark mutual fund also launched the first gold exchange-traded fund called Gold BeEs.

Goldman Sachs bought Benchmark mutual fund in 2011. Reliance mutual fund (now Nippon Asset Management) bought Goldman Sachs in 2015.

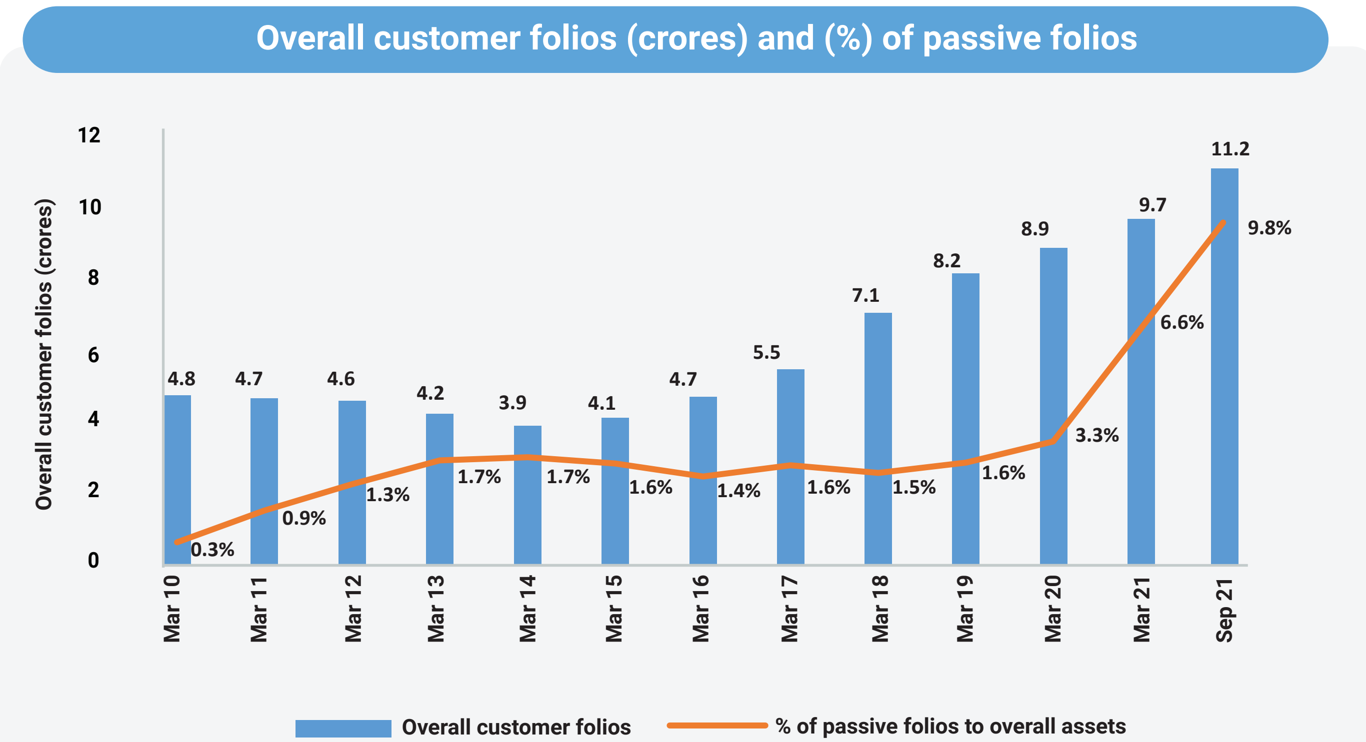
In the last five years, the Indian passive market took off, with assets growing more than 1200% growth in absolute terms. From March 2016, passive assets under management have grown from ₹ 22,409 crore to ₹ 3,10,330 crore in March 2021, at a CAGR of 69%. As of September 2021, there were around 160 passive schemes in India.

India's largest fund
is a passive scheme
- SBI ETF Nifty 50 fund - having
more than ₹ 1.1 lakh crore of AUM
as of September 2021

Breakout growth of passive assets in India

The number of passive products has been steadily increasing over the years in India. On the back of strong demand from customers, both traditional AMCs and new age technology-based AMCs have launched many innovative passive schemes. The number of passive products has almost doubled over the previous two years.

The rise of interest in passive investing in India is evidenced by the growth in the number of customer folios in passive products.



Source : AMFI
Financial year

Highlights

- Passive folios as a percentage of overall folios have almost tripled over the last two financial years.
- While overall customer folios have grown at 7% CAGR, passive customer folios over the last decade have grown at a CAGR of 43% as of March 2021.

Hockey stick growth of passive assets in India

While passive assets have increased sharply over the past decade, the growth has come in the form of a sharp growth at the start, slow growth in the middle followed by a parabolic spurt at the end.

Passive assets have almost doubled in the previous financial year (in ₹ crores)

Year	Overall AUM	Total passive AUM	% of passive assets to overall assets
Mar 10	6,13,979	2,547	1%
Mar 11	5,92,250	6,917	1%
Mar 12	5,87,659	11,493	2%
Mar 13	7,02,494	13,124	2%
Mar 14	8,25,243	13,205	2%
Mar 15	10,82,757	14,715	1%
Mar 16	12,32,824	22,409	2%
Mar 17	17,54,619	49,916	3%
Mar 18	21,36,036	77,694	4%
Mar 19	23,79,584	1,39,073	6%
Mar 20	24,70,882	1,72,008	7%
Mar 21	32,17,195	3,10,330	10%
Sep 21	37,40,791	4,13,097	11%

Source: AMFI

Highlights

- Passive assets have almost doubled in the previous financial year.
- Passive assets have grown at a CAGR of 62% in the last decade, while the overall AUM of Indian mutual funds has grown at a CAGR of 18% as of March 2021.
- Passive assets as % of overall assets have now reached 11%.

What is causing the inflow of funds into passive assets in India?

An analysis of trends in developed economies such as the US shows three key trigger points that have caused the growth of passive assets. In India, too, the same factors have played out. They are:

- Underperformance of active funds
- Cost
- Regulatory and government policies

Underperformance of active funds

The debate over active versus passive investing has grown louder in the previous two years. This is mainly due to the large underperformance of active funds.

Despite a strong run-up in Indian equities in the first half of 2021, performance of the majority of active funds in the large-cap and mid/small-cap fund categories lagged their respective benchmarks.

Percentage of equity funds underperformed their benchmark (based on absolute return)

Fund category	Comparison index	1 year (%)	3 year (%)	5 year (%)	10 year (%)
Indian equity large cap	S&P BSE 100	86.21	86.67	82.72	65.93
Indian ELSS	S&P BSE 200	53.66	76.19	76.19	48.57
Indian equity mid/small cap	S&P midcap 400 mid small cap index	57.14	48.65	69.57	40.3

Source: SPIVA, S&P Dow Jones Indices LLC, Morningstar and AMFI. Data as on June 30, 2021.

Note: *To track underperformance, we have used SPIVA (which stands for S&P indices versus active funds). The SPIVA report is used worldwide to compare the performance of active funds against S&P benchmarks in various markets. Since its first publication in 2002, the SPIVA Scorecard has served as the de facto scorekeeper worldwide of the active versus passive debate.*

Highlights

- **Indian equity large-cap funds:** 86% of funds underperformed the benchmark in the one-year time frame as of June 2021. Over a 10-year period ending in June 2021, most actively managed large-cap equity funds in India underperformed the large-cap benchmark.

- **Indian ELSS funds:** The S&P BSE 200 returned 59% over a one-year period ending in June 2021, with 54% of funds underperforming the benchmark. Over the three, five, and ten years ending in June 2021, 76%, 76%, and 49% of funds, respectively, underperformed the benchmark.

- **Mid-/small-cap funds:** The benchmark for Indian equity mid-/small-cap funds, the S&P BSE 400 mid small cap Index, was up 90.56% over the one-year period ending in June 2021. Over H1 2021, 58% of the funds underperformed the benchmark. Among all the categories evaluated in the SPIVA India Scorecard, the Indian Equity Mid-/Small-Cap category fared the best for active funds, with the majority of them managing to beat the S&P BSE 400 MidSmallCap Index over the 10-year period ending in June 2021.

Cost

What is the Cost/Expense ratio in mutual funds?

The expense ratio is defined as the annual fee that an investor is charged for managing their funds. The expense ratio includes numerous charges for running the mutual fund plan such as administrative cost, marketing cost, promotion cost, distribution cost, compliance cost, and shareholder service cost, among many others. These costs get reflected in the scheme's expense ratio, which substantially impacts the take-home returns for investors.

Example: If you invest ₹ 2,00,000 in a fund that has an expense ratio of 2% per annum, then it means that you need to pay ₹ 4000 per year to the fund to manage your money. Also, if a fund returns equal to 18% and has an expense ratio of 2%, then you would get a return equal to 16%. The Net Asset Value (NAV) of a fund is reported after deducting all fees and expenses.

Significant components of expense ratio

- **Management fee**

  The management fee is the compensation for the fund manager's expertise. Fund managers possess a high level of relevant fund management experience and professional credentials. They invest a lot of time and effort in researching the market trends to invest in different asset classes and making calculated predictions that can generate optimum returns for the investors.

- **Maintenance/Administrative fee**

  A mutual fund portfolio requires keeping all records of the transaction, offering customer support, etc. All these operational and administrative tasks are charged as a maintenance fee.

- **Brokerage**

  As we know, mutual fund schemes come in direct plans and regular plans. The difference between the two is that in the case of a regular plan, a mutual fund house pays commission to the broker as distribution expenses, whereas, in the case of a direct plan, no such commission is paid. Hence, regular plans of mutual funds come with a higher expense ratio than that of a direct fund.

Simply put, the expense ratios of direct plans are lower than those of regular plans. And this difference is directly attributable to the fee that goes to the distributor who facilitates the transaction for you.

Are the Indian mutual funds' expense ratio too expensive?

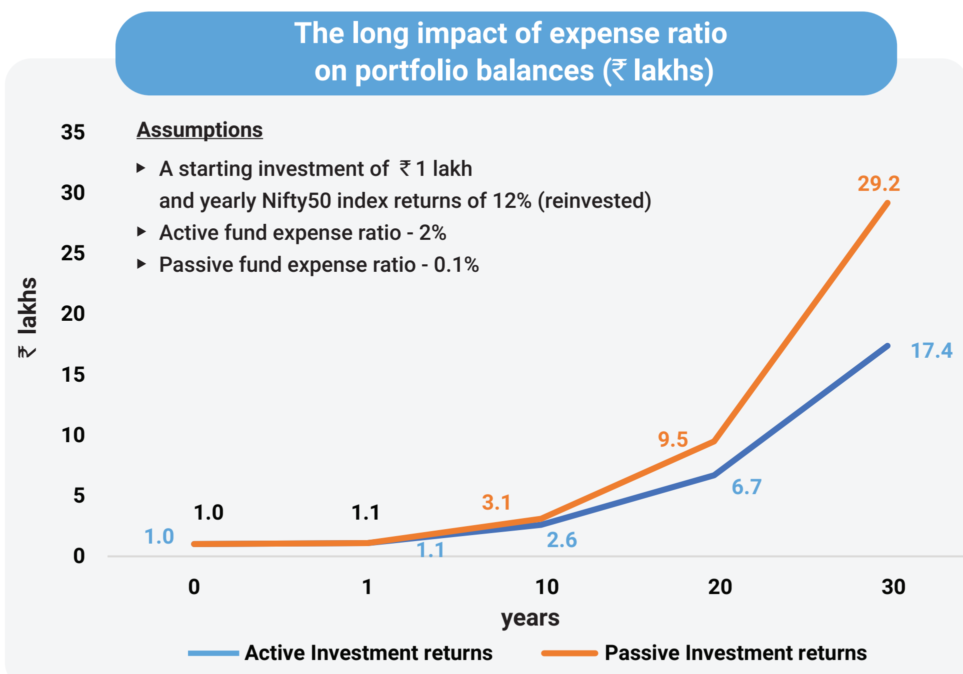
The Morningstar Global Investor Experience (GIE) study of 2017, found that India is among the most expensive countries in the world in terms of costs charged in equity and hybrid mutual funds.

However, SEBI, the regulator has continuously taken steps in reducing the overall costs such as the ban on upfront commission, capping the TERs (Total expense ratio), and slabs of TER based on the AUM of the scheme among many others.

There are many factors that investors cannot control when investing in an active mutual fund, not least of which include the market's direction and the fund manager's portfolio decisions. Investors can, however, control how much they pay for an investment.

Simply put, **Net returns to the investor = Gross returns from the fund - Fees and expenses of running the fund.**

However, to fully understand the impact of cost on returns over a long period of time, look at the example/chart.



As can be seen in the previous chart, ₹ 1 lakh invested in the active fund grows to ₹ 17.45 lakh while the same investment grows to ₹ 29.17 lakh over 30 years with the passive fund. While a difference in expense ratios may seem small in the short term, they add up over the long term. The difference in returns is due to a single factor - Cost (expense ratio).

In India, the average expense ratio of actively managed large cap funds hovers in the range of 1.5% to 2.5%. The average expense ratio of passive funds hovers in the range of 0.05% to 0.3%.

Regulatory and government policies

In India, the Government and SEBI have taken a number of steps to boost the growth of the mutual fund industry. Below are some of the milestone policies which paved the way for growth in mutual fund and passive assets.

2012

Incentives for penetration beyond the top 30 (T30) cities

- Till 2012, the maximum an equity mutual fund could charge was 2.5 percent, including service tax. In 2012, SEBI allowed AMCs to charge expenses of 30 basis points extra for mutual fund penetration beyond the top 30 (T30) cities. This paved the way for higher penetration in cities beyond the top 30 (B30).

  SEBI has reclassified top 15 ("T15") and beyond the top 15 ("B15") as T30 and B30, respectively, to encompass a wider set of cities that have lower penetration after seeing the share of B15 cities improve regularly in previous years.

2013

Launch of Direct schemes

- Effective 1 January 2013, all asset management companies (AMCs) launched direct mutual fund plans for all open-ended schemes. Before 2013, only the regular mutual fund plans were available.

2014

Government's disinvestment through ETF Route

- The government launched disinvestment drives through ETFs. This announcement helped create large awareness and interest in ETFs.

2015

EPFO (Employees' provident fund organization) started investing in MF's

- The EPFO (Employees' provident fund organization) started investing in equities through large-cap ETFs in 2015.
- The total EPFO allocation in ETFs was Rs 1.03 trillion, as of March 31, 2020. (Source: Moneycontrol)

2017

Re-categorization and rationalization of mutual fund schemes and 'Mutual Funds Sahi Hai' campaign

- SEBI announced the re-categorization and rationalization of mutual fund schemes. SEBI mandated fund houses to manage only one product offering in each style category. This enhanced transparency since investors could easily compare the performance of fund offerings in each style category.
- AMFI launched the 'Mutual Funds Sahi Hai' campaign, giving a huge boost to the mutual funds, especially in tier 2+ cities.

2018

Introduction of Benchmark - Total Return Indices (TRIs)

- Introduction of benchmarks: SEBI required that fund managers benchmark performance of equity funds against total return indices, emphasizing the importance of dividend payments in addition to capital appreciation when evaluating portfolio returns. This helped enhance the cost-effectiveness quotient of passive investment strategies.
- SEBI also announced that large-cap equity funds must invest at least 80% of their portfolio in large-cap stocks (top 100 stocks) and mid-cap funds must invest at least 65% in mid-cap stocks. After this announcement, active fund managers lost the flexibility of allocating assets to other categories.

2021

Launch of silver exchange-traded funds (ETFs)

- Silver acts as a hedge against economic uncertainties and provides diversification to investments. Though silver has a high correlation with gold, it has a low correlation with Indian equities. When equity tumbles, silver delivers positive returns. Like gold, silver acts as a hedge during uncertainties.
- SEBI, in its board meeting on September 28, 2021, approved the launch of silver exchange-traded funds (ETFs) in India. So far, only gold ETFs have been available. Fund houses buy and store physical gold on behalf of the investors in ETFs. Similarly, silver ETFs are likely to enable investors access to paperless silver.

06 Outlook for mutual funds and passive investing in India

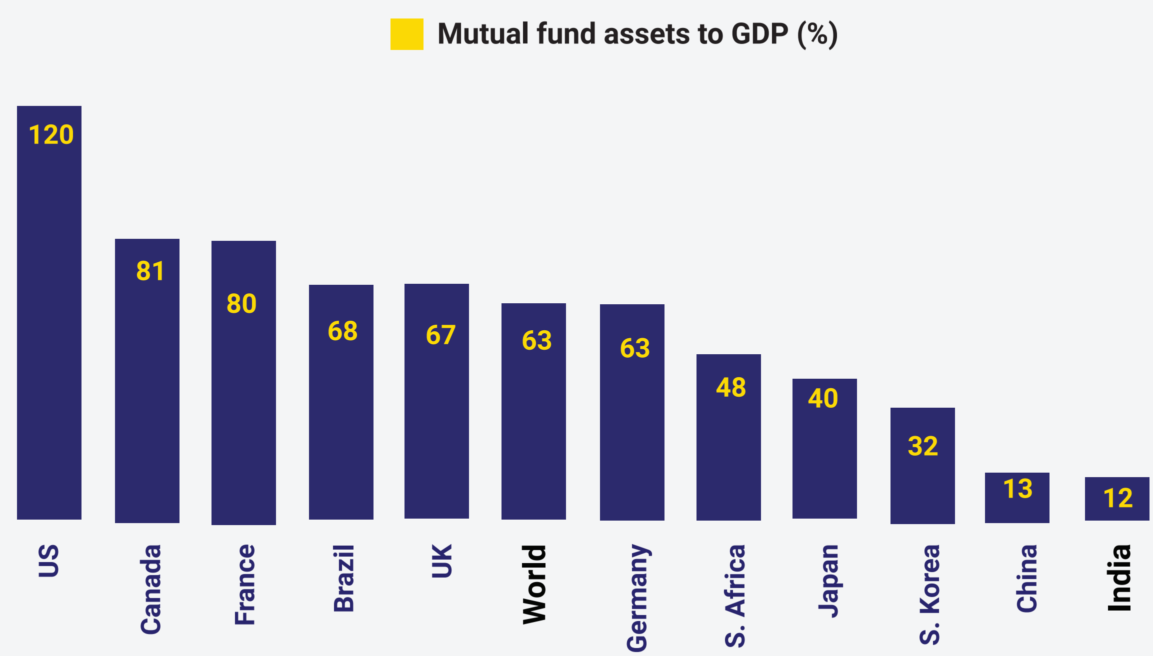
Drivers of growth in mutual fund industry

Low penetration - High potential:

While mutual funds are emerging as a major investment tool for Indian investors, the penetration remains low yet. Less than 2% of Indians invest in mutual funds compared to 45% of households in the US that have a mutual fund investment.

India's low AUM-to-GDP ratio at 12%, less than a fifth of the global average, reflects poor penetration. But this also means the mutual fund industry has a vast potential to grow in the country.

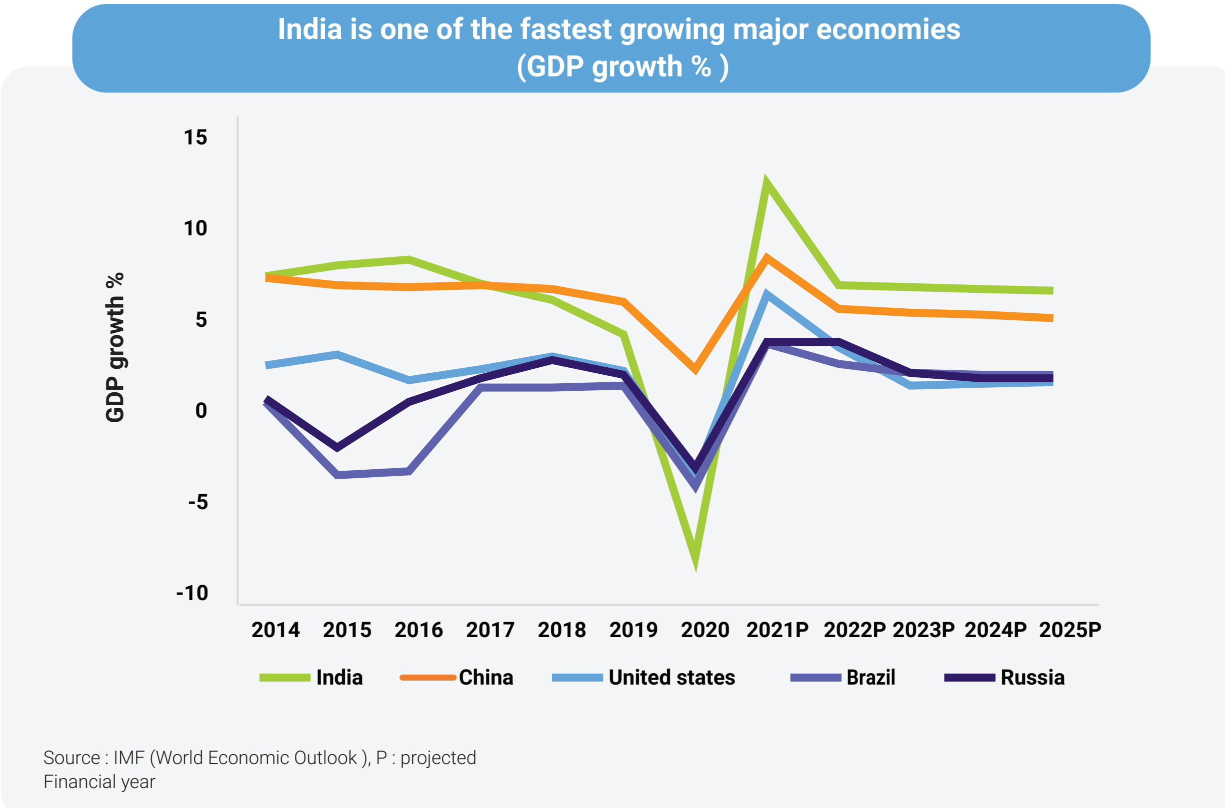
India's mutual funds assets as a % of GDP is among the lowest



Source: Jefferies Report 2019
Financial year

Despite the AUM growth at a CAGR of more than 20% over the previous five years, Indian mutual fund AUM to GDP ratio remains significantly low at 12% as compared to a global average of 63%.

GDP growth:

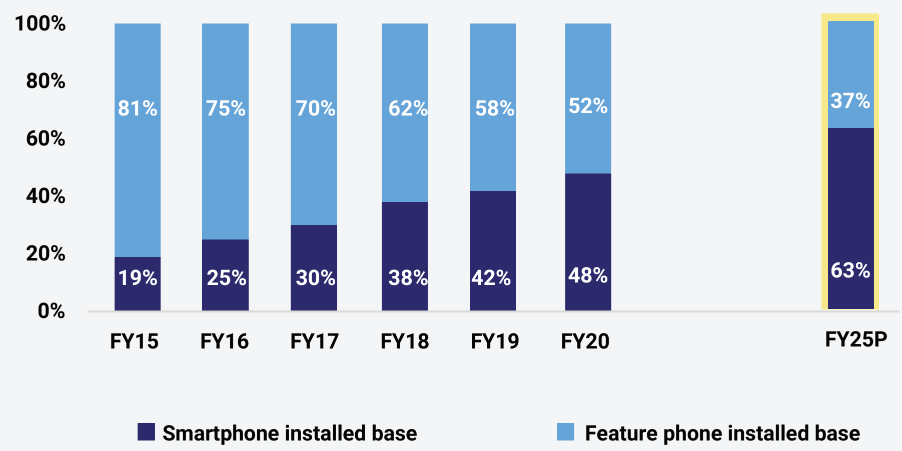


	2014	2015	2016	2017	2018	2019	2020	2021P	2022P	2023P	2024P	2025P
India	7.4	8	8.3	7	6.1	4.2	-8	12.5	6.9	6.8	6.7	6.6
China	7.3	6.9	6.8	6.9	6.7	6	2.3	8.4	5.6	5.4	5.3	5.1
United States	2.5	3.1	1.7	2.3	3	2.2	-3.5	6.4	3.5	1.4	1.5	1.6
Brazil	0.5	-3.5	-3.3	1.3	1.3	1.4	-4.1	3.7	2.6	2.1	2	2
Russia	0.7	-2	0.5	1.8	2.8	2	-3.1	3.8	3.8	2.1	1.8	1.8

India is one of the fastest-growing major economies in the world. As India races to become a $5 trillion economy, its huge size and low penetration of financial services provide enormous business opportunities for the mutual fund industry to grab a big slice in the financialization of savings.

Digitization and mobile data penetration:

Data savvy and younger users to drive adoption of smartphones



Note: P: Projected; Percentages expressed on the number of installed base of phones
Source: CRISIL Research

India has seen a tremendous rise in financial technology (fintech) adoption in the past few years. At 87%, the country's adoption rate is the highest globally. It is much higher than the global average of 64% (Source: InvestIndia). The digital presence of aggregators, asset management companies, and wealth management players is enhancing distribution reach.

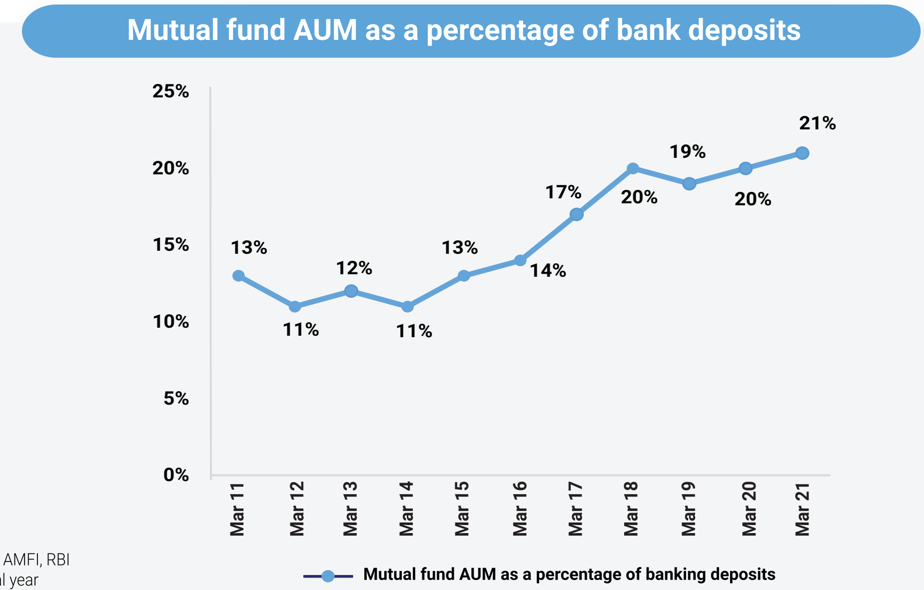
Among the many fintech innovations in India, UPI (Unified Payments Interface) is playing a pivotal role in advancing financial inclusion by making digital payments and investing more accessible across the country. Technology is also playing an important role by progressively reducing the cost of reaching smaller markets.

Assets Under Management (AUM) of the industry is already growing at a rapid pace. In a challenging year, it grew by 30% from ₹ 24.70 trillion in March 2020 to ₹ 32.17 trillion in March 2021. Mobile phones and inexpensive data had a huge role to play in this.

Key trends in financial services - Mutual fund industry

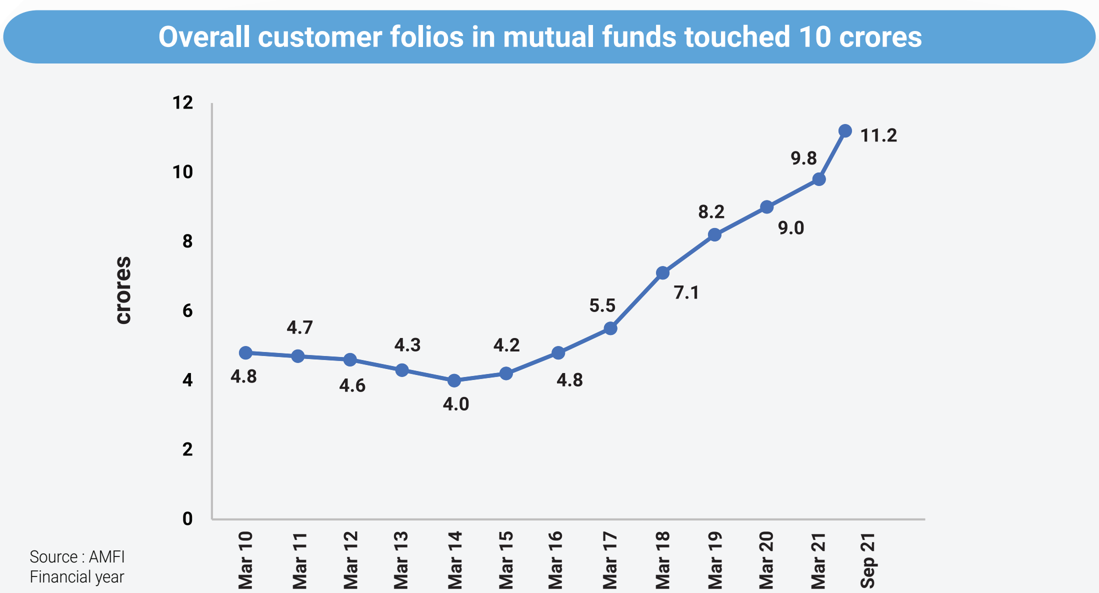
Increasing preference for mutual funds versus traditional financial products

Mutual fund AUM as a percentage of banking deposits witnessed a sharp increase from 13% in March 2011 to 21.30% in March 2021. The mutual fund industry has seen over 20% CAGR growth in the last six years. As the awareness of the advantages of mutual funds over traditional investments such as fixed deposits and saving deposits rise, there would be a further increase in the number of investors choosing mutual funds, especially passive funds, as part of their household savings and investments.



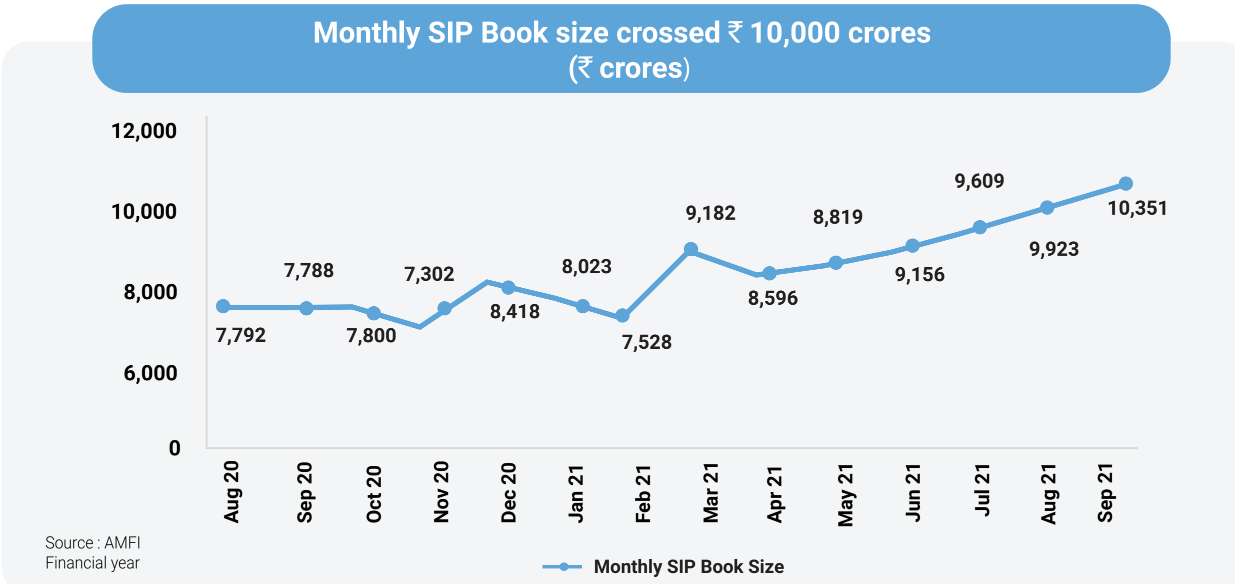
Source : AMFI, RBI
Financial year

The industry added 82 lakh new customer folios in the last financial year. Also, the overall number of folios crossed 10 crore mark recently.



Source : AMFI
Financial year

SIP has become the most preferred mode of investment in mutual funds for investors. The rising popularity of systematic investment plans (SIPs) is a big growth vehicle. The average monthly SIP contribution has nearly tripled in the last five fiscals. Recently the monthly SIP book has crossed the milestone of 10,000 Crores.



Source : AMFI
Financial year

Increase in individual investor AUM

The share of institutional investors — corporates, banks, non-banking financial entities, and foreign institutional investors — has gradually declined from 56.13% in March 2014 to 46.32% in March 2021. This is due to the faster growth in individual investor AUM at 23.54% CAGR than institutional AUM growth at 16.78% CAGR over the period.

**Growth of individual investor AUM
(₹ trillion)**

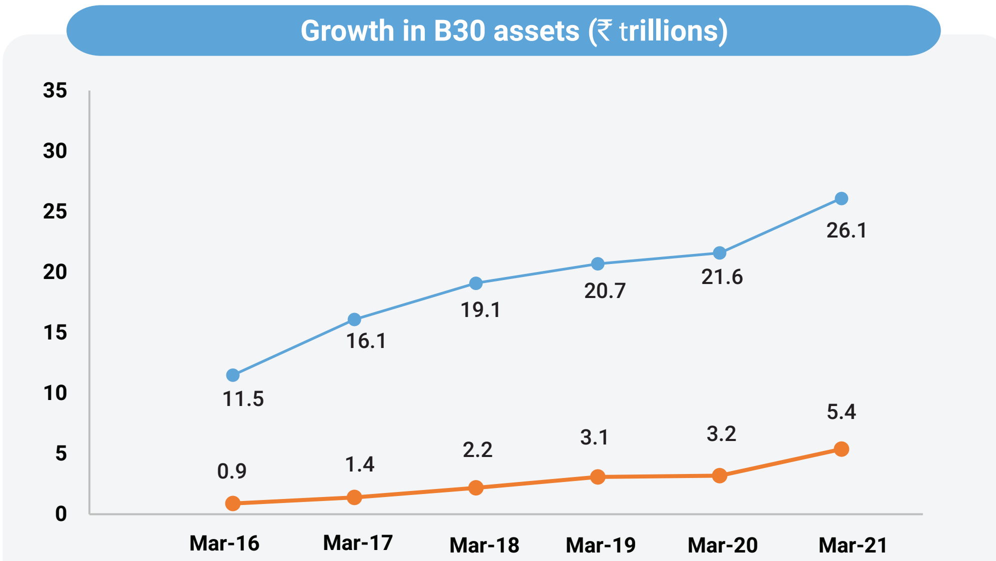
Category	Mar 14	Mar 15	Mar 16	Mar 17	Mar 18	Mar 19	Mar 20	Mar 21	CAGR (Mar 14 to Mar 21)
Corporates	4.4	5.6	6.4	8.8	10.0	10.1	10.9	14.2	17.9%
Banks/FIs	0.4	0.6	0.8	1.1	0.8	0.8	0.7	0.5	3.3%
FIIs/FPIs	0.0	0.16	0.1	0.1	0.1	0.1	0.0	0.0	-4.8%
Institutional sub-total	5.0	6.4	7.3	10.0	11.0	11.0	11.8	14.9	16.7%
Retail investor	1.6	2.4	2.6	3.8	5.3	6.4	4.7	7.0	23.3%
High net worth individuals	2.3	3.1	3.5	4.7	6.3	7.1	8.2	10.2	23.7%
Individual sub-total	3.9	5.5	6.1	8.5	11.6	13.5	12.9	17.2	23.5%
Total	8.9	12.0	13.5	18.5	22.7	24.5	24.7	32.1	20.0%

Source : AMFI, CRISIL

Growth in B30 assets

The next leg of growth is expected to come from Tier 2 and Tier 3+ cities (called B30 by SEBI) that have comparatively lower penetration. In March 2021, the monthly average AUM in the top 30 cities stood at ₹ 26.93 trillion compared with ₹ 5.23 trillion for those beyond the top 30. While T30 assets have grown at a CAGR of 17.8%, B30 assets have grown at a CAGR of 43.80% over the last 5 years.

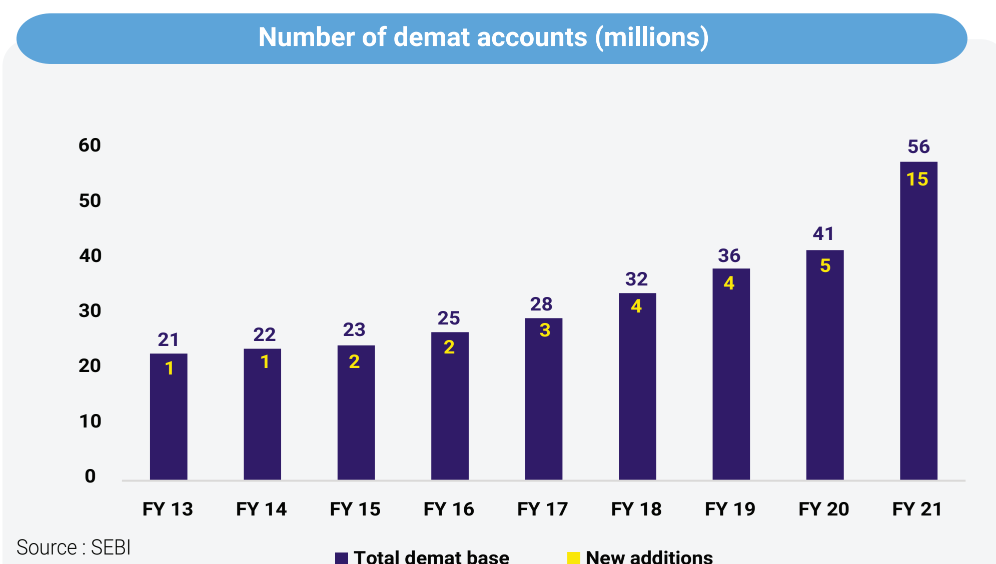
The SEBI has reclassified top 15 ("T15") and beyond the top 15 ("B15") as T30 and B30, respectively, to encompass a wider set of cities that have lower penetration after seeing the share of B15 cities improve regularly over the previous years.



Source : AMFI
Financial year

3X growth in demat accounts

The number of demat accounts, needed to buy ETFs (Exchange Traded Funds), has more than doubled in FY21 compared to the previous fiscal.



Source : SEBI
Financial year

Innovative Passive products

While passive instruments are commoditized products, fund houses have endeavored to produce innovative research-based products in the passive category to gain an edge over others and acquire market share.

The Indian passive market has seen several innovative products launched in the last couple of years. Some of these include:

Equal-weight Nifty Index:

Unlike the market cap-weighted index, equal-weight Nifty index gives equal weight to all stocks in the index. In other terms, an equal amount of money is invested in the stocks of all companies that make up the index. The equal weightage can help to lower the concentration risk of the portfolio and rebalancing gives consistent exposure to top movers in the economy

Nifty Next 50:

The Nifty Next 50 Index represents the balance of 50 companies from Nifty 100 after excluding the Nifty 50 companies. This means an opportunity to participate in the growth of future market leaders and generate superior returns with relatively lower risk. The Nifty Next 50 is well diversified across sectors with relatively less exposure to financial services, unlike the Nifty 50. It provides a better risk to reward ratio than the Nifty 50.

International Index investing

International funds have gained traction among Indian mutual fund investors. Investing in international stocks such as Alphabet, Amazon, Tesla through an ETF route is now possible for Indian investors.These indexes offer geographical diversification, besides providing investment opportunities that may not be otherwise available in India. Some of the recent international ETFs are:

- Motilal Oswal Nasdaq 100 ETF
- Mirae Asset NYSE FANG Plus ETF
- Edelweiss MSCI India Domestic & World Healthcare 45 ETF

Bharat Bond ETFs

Bharat Bond ETF invests in bonds of public sector companies. This ETF offers the best of the below investment classes:

- Bonds - predictable returns and Fixed maturity date
- Mutual Funds - diversification, expert management, and tax efficiency.
- ETFs - high liquidity, low cost, and transparency.

ESG ETFs

Environmental, Social and Corporate Governance (ESG) investing has gained traction across the world including in India. Sustainable investing concepts such as ESG aim to generate long term wealth while having a positive impact on the society. Recently, Mirae Asset mutual fund launched its Mirae Asset ESG Sector Leaders ETF in India.

Momentum ETFs

Momentum investing is the belief that certain stocks in strong uptrends can continue rising, while stocks that are faltering can continue plummeting. In developed markets, a number of momentum indexes have been created that are broadly utilized by momentum-focused exchange traded funds (ETFs).

Recently, in India too, HDFC AMC has filed for a launch of the new Nifty 200 Momentum 30 Index. This index aims to track the performance of the top 30 companies within the Nifty 200 selected based on their normalised momentum score.

Thematic Index/ETFs

Thematic investing, also known as theme-based investing, is a top-down investing strategy that seeks to take advantage of opportunities created by macroeconomic, geopolitical, and technological developments. Some of the recent and upcoming thematic/sectoral based index funds/ ETFs in India are:

- Navi Nifty Pharma Index Fund
- HDFC Nifty IT ETF
- ICICI Prudential Infrastructure ETF
- Navi Nifty India Manufacturing Index Fund

All of the above mentioned trends bode well for the mutual fund Industry. Both the Indian and global experiences show that growth in mutual fund assets is accompanied by a growth in the percentage share of passive funds against actively managed funds.

At their core, passive funds also remain simple and easy-to-understand products. As the investor pool matures and new investors enter the market, many of them are more likely to opt for passive investment products as part of their portfolio.

05 Key trends and innovations that will shape passive investing in India

Changing investor attitudes towards low-cost products:

As the investor pool matures, investors have started demanding more from asset management companies. With the proliferation of educational initiatives by aggregators, AMFI, and finance influencers, investors acknowledge that funds' costs are a significant factor for value creation.

Automation and technology to further reduce costs:

- **Automation (of processes):**

  A fairly big portion of the work of fund management teams involves back-end processes. With more sophisticated technology for both internal and external infrastructural systems, asset management companies can save costs associated with managing the funds and pass on the savings to investors.

  Also, growing assets make a great case to reduce the TER (Total expense ratio) significantly as administrative costs, compliance and shareholder servicing costs among many others can be further reduced with the help of technology.

- **Fully digital distribution and switch to direct plans through digital platforms:**

  Earlier, asset management companies relied on independent financial advisors, national distributors and banks to distribute their products thereby increasing costs of marketing and brokerage fee of the product. Newer asset management companies are starting to embrace fully digital distribution through direct plan platforms as a matter of necessity or constraint, thereby creating an opportunity to keep costs lower than their traditional peers. With the rise in the adoption of digital purchases of mutual funds through new-age fintech platforms, this trend is likely to keep pace.

Passives will take center stage in the investor portfolios:

Traditionally, actively managed large-cap funds used to dominate the core of every investors' mutual fund portfolio. However, this is getting replaced with passive index funds and ETFs for reasons pointed out earlier that include:

1) Increasing inability of active large-cap funds to outperform the index.
2) Lower costs of passive funds.
3) Increasing awareness of investors about passive funds

There are a number of trends seen in developed economies that could find their way into India in the next few years. Here are a few mentioned below:

- **Goal-based investment products**

  Goal-based investing is an approach that emphasizes investing with specific life goals in mind. One of the most significant frictions in the investment behaviour of customers is the cognitive load associated with selection of funds among the thousands of schemes that exist in the market. Easy-to-understand and straightforward goal-based investment products such as retirement and child care ETF funds will make it easier for customers to understand and invest.

- **Direct Indexing**

  Direct indexing (DI) allows investors to construct customized portfolios in SMAs (Separately Managed Accounts) based on indexes. Using DI, investors can customise an index portfolio, factor weightings, increase/decrease allocations to a specific industry/ sector/ size/ style.

  For example, an investor could double the weightage of technology companies in an index and remove all fossil fuel stocks or create an equal-weighted or dividend-weighted index versus cap-weighted.

  DI innovation is on the rise in developed countries. In India, fintech companies such as Smallcase have built similar products.

- **Smart beta products**

  Smart beta funds, also known as strategic beta funds or factor-based funds, track and mimic the underlying benchmark indexes in the same way as passive ETFs and index funds. The difference is that smart beta funds select stocks based on factors other than just weighting holdings by market capitalization.

  Globally, smart beta funds have already garnered $1.12 trillion worth of investments as of March 2021, according to ETFGI's Smart Beta industry landscape report.

  In India too, there are growing conversations on rule based or smart beta investing approaches, but it is yet to gain traction like in the developed markets.

- **Sustainable and socially responsible investing**

  Globally, ESG investing is attracting a lot of interest. The COVID-19 pandemic is increasing the drive towards sustainable and socially responsible investment practices. Across the world, investors have a choice of over 3000 schemes. In India, ESG investing is still nascent, but awareness is growing.

SEBI has been subtly highlighting the importance of ESG for many years for businesses operating in India.

- In 2012, the top 100 listed companies were mandated to include a business responsibility report as part of their annual reports.
- In 2013, India became the first country in the world to mandate corporate social responsibility (CSR) for companies that meet certain criteria to spend 2% of their average net profit for social development (under Section 135 of the Indian Companies Act).
- In 2020, SEBI introduced new norms for ESG disclosures for the top 1,000 listed entities by market capitalization.

Many market observers expect the Indian Government to include ESG investing under the ELSS category and make investments in ESG funds eligible for tax benefits under Sec 80C.

Zero fee funds - Index and ETFs

US Fidelity Investments became the first financial company to offer a no-fee index mutual fund. Within a month, Fidelity had attracted roughly $1 billion into its two portfolios. After three years, Fidelity was managing total assets worth $18 billion across four zero-fee schemes for retail investors.

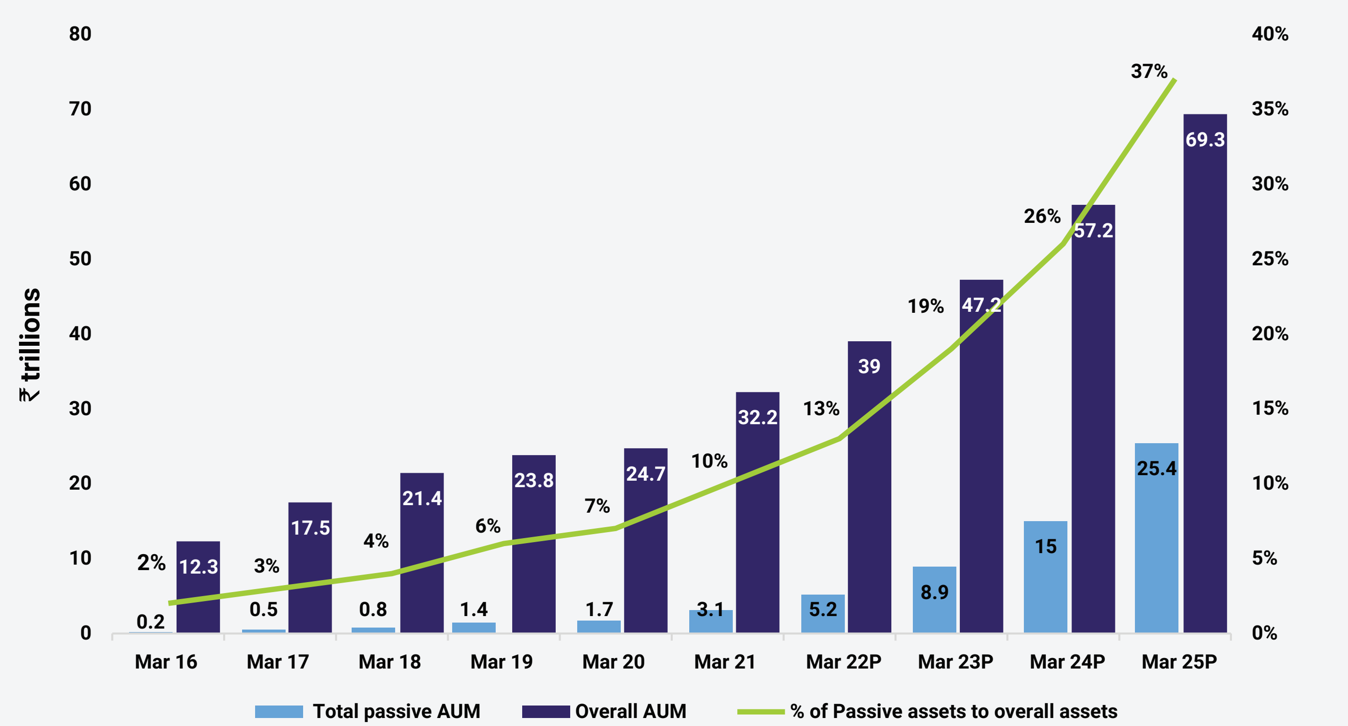
We may even see the launch of zero-fee funds in India as fintech AMCs intensify their battle to capture a larger share of the customer wallet from investment advisors. While zero-fee funds may add to the cash burn, the strategy may pay off in terms of higher brand visibility and an opportunity to cross-sell high-yielding financial products.

07 Dawn of passive investing in India

In summary, given the trends in the industry such as the popularity of mutual funds beyond larger cities, increasing awareness of nuances of financial products amongst a large section of investors, growing urbanization & digitization, large-scale advertising campaigns by the AMFI on passive investing and new-age tech-based and traditional AMCs promoting passive funds, we believe that the momentum in passive investing will continue to grow.

We estimate that passive assets will cross ₹ 25 trillion of AUM by 2025 from an AUM of ₹ 3 trillion in March 2021, which is a growth of more than 8X. We also estimate that passive assets will grow to constitute 37% of the overall assets in the mutual fund industry by 2025 from the 10% as of March 2021.

Dawn of passive investing in India (₹ trillions)



Source : AMFI, Finity research, P : Projected Financial year

Forecasting methodology:

We have assumed the growth rate of passive assets over the next four years ending March 2025 at a CAGR of 69.15% which was actually the CAGR for the previous five years ending March 2021. We have also assumed the overall growth rate of mutual fund assets over the next four years ending March 2025 at a CAGR of 21.15% which was the actual CAGR for the previous five years ending Mar 2021.

The rise of passive investing is one of the simplest and yet among the most exciting trends that is happening in the Indian financial markets. It is also the antithesis of the belief that highly sophisticated and complex financial products could lead to better returns in investing.

Many experts believe that the underperformance by a majority of active mutual funds is expected to continue. In fact, as investors pour trillions of rupees into passive products, it could reduce the potential for alpha even more as basket buying and selling of stocks could result in tighter correlations.

When combined with rupee-cost averaging (also called SIP), another simple but powerful tool, passive investing has the potential to truly democratize wealth creation.

The power of passive investing is evident in the fact that several new-age technology based asset management companies are launching passive products as a key focus area. This could launch a megatrend that could dwarf the growth of mutual funds over the last 25 years.

This report, combined with our GoPassive Investing Conclave 2021, is our humble effort to help create awareness for a product that we truly believe could help accelerate financial progress for Indians.

We welcome your suggestions, comments, and feedback at **gopassive@finity.in,** as we seek your partnership in helping create awareness about passive investing in India.

Good luck and happy passive investing!

The team

Harish Sai

Divya Nair

Neenad Kadam

Sameer Mohan

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