Sustainable Path for Fixed Income Passive Investing

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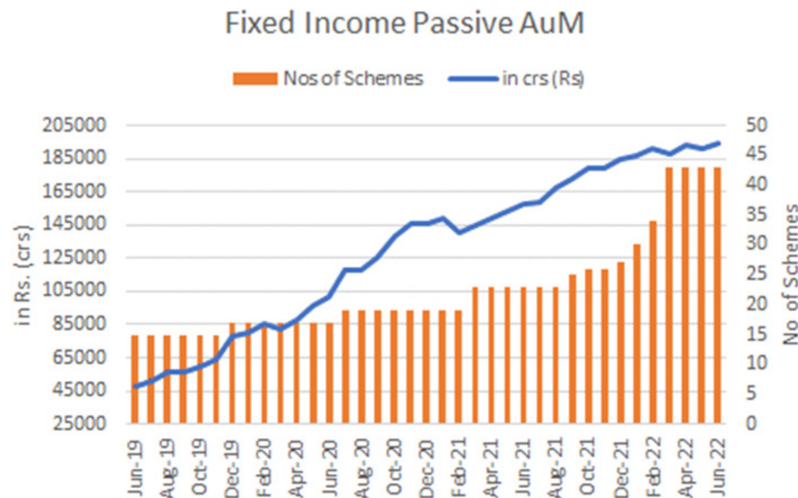
The main difference between passive and active investing can be surmised to a scheme's appetite to a change in a market's construct. Active funds are motivated to continuously seek the most attractive opportunities basis a certain risk/reward within the fund mandate whereas the passive approach is indifferent to valuation. Passive strategies are supposed to mimic the index that they track regardless of whether a strategy is cheap, expensive or outrightly risky.

Net flows into passively managed funds globally have gone up significantly in recent years, as investors prefer the lower expense structure & simplicity of passive funds. Additionally, under-performance of active funds compared to their benchmarks in many categories has also played a role in turning the focus of investors towards passives. Indian mutual fund industry has also witnessed considerable AUM growth under passive funds. Total AuM under passive funds has grown from INR 52,368 crs in March 2017 to INR 499,319 crore in March 2022, a growth rate of 57% (Source: The Economic Times, https://bit.ly/3RHXTAb)

Development of Passive Fixed Income Schemes in India

While equity ETFs have received significant attention in recent years, passive fixed income funds have also witnessed meaningful traction in the last 5 years. The preference of Indian fixed income investors for a predictable return in a period of nominally lower fixed deposit rates, lack of alternate opportunities (lesser FMP launches) & issues in credit-oriented strategies have turned investors towards passive strategies. As can be seen from the chart below, fixed income AUM in passive strategies has grown by a substantial 58% in the last 3 years from INR 472 billion to INR 1.94 trillion across 43 schemes as of June 2022 compared to 15 schemes as of June 2019.

Chart 1



Source: MFI explorer, Passive Schemes include schemes pursuing rolldown strategy as per UTI MF research

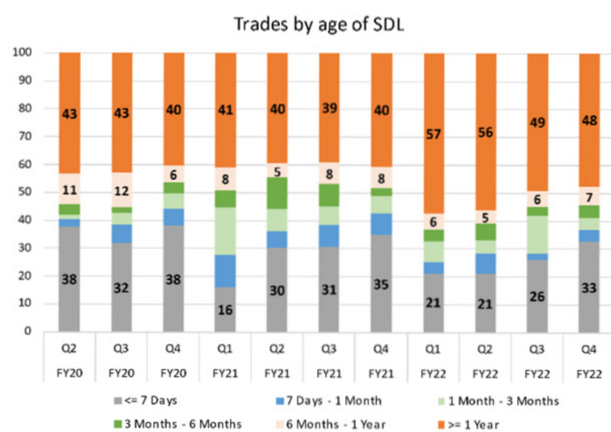
Out of the total 98 new schemes approval filed with SEBI since 2021, 38 schemes have been in fixed income category (Source: UTI MF research), reflecting the high investor interest in passive fixed income space. Interestingly, unlike the advanced economies where passive fixed income schemes comprise of multiple strategies across duration spectrum in Government bonds, corporate bonds & money market securities etc., Indian passive fixed income space has been characterised by concentration of target maturity or roll down strategies. A target maturity or a roll down strategy primarily involves creating a portfolio of a certain maturity and permitting the maturity to gradually reduce over a period, till the fund hits the target date objective. Hence, any inflows/outflows in a rolldown strategy are deployed to maintain a specified maturity. For example, a 5 year roll down strategy might have to buy securities to maintain portfolio maturity of 3 years if the strategy gets inflows after 2 years. This gives investors the benefit of visible returns (assuming no adverse credit events) alongside the freedom to enter and exit on any business day.

Out of the INR 1.94 trillion AuM of passive fixed income, INR 1.85 trillion comprises of target maturity/roll down strategies (Source: UTI MF research). 34 out of 38 new passive schemes filed with SEBI for approval in the last 2 years are roll down (Source: UTI MF research).

The skewed interest in roll down strategies probably reflects investors preference for a predictable duration/credit profile & consequently preference for visibility on returns. Some investors might consider a roll down strategy to be a win-win where they have a broad line of sight on the return profile of the fund owing to the roll down nature of the scheme in an open-ended format thus removing one of the limitations of the FMP structure.

Lately, there have been increasing number of target maturity index schemes launched with portfolio comprising of PSUs, State development loans (SDL's), Government bonds (G-sec) etc. While these are high-quality portfolios which carry low credit risk, all stakeholders need to be aware of the trade-offs when entering into unchartered waters with a category growing extremely rapidly in an evolving market environment. As can be seen by the chart below, SDL's which have been issued for more than a year comprise approximately 45% of the trades on an average in the period under study. As can be seen from the chart 3 below, majority of the volume in debt market is concentrated in Government bonds. While these issues might not impact these schemes on a steady state basis, lower liquidity in non-Government bond market might present a problem of impact cost in case of significant flows as the vintage of these schemes increases.

Chart 2



Source: CCIL

Chart 3

Source: CCIL

Conclusion

The growth of passive debt funds today presents a great opportunity to bond investors & issuers alike to optimise their needs & provide the much-needed deepening to the corporate bond market. In fact, bond issuers can align their issuance with the composition/ maturity of these indices to improve their borrowing costs while providing the required inventory for these index funds for construction of their portfolio.

While the assumption in these products is that the investor has invested with a mindset to stay till the horizon of the rolldown, there are always **possibilities of large sized inflows/outflows** due to economic events or liquidity needs of investors over the course of the fund. This might leave the remaining investors with **meaningful impact cost or result in general market disruption** in case of large sized flows in these funds. In case of non-sovereign index funds, stakeholders also need to be well aware that the **credit profile of the fund based** on a certain methodology might result in an **undesired outcome**, i.e., the fund taking exposure to an issuer/sector to which investors might not be comfortable. While it might be easy for an index to rebalance a security in case of an adverse credit event, **it might not be easy for the index fund to rebalance a security in the specified time**. Investors might need to **diversify their portfolio across strategies rather than investing in similar strategies across different schemes**. As the category size increases, it might also be prudent to have a **minimum liquidity criterion/ entry/ exit guidelines** in these funds at some point of time to service large sized flows while avoiding market disruption.

Passive funds have greatly benefitted investors across the world & are likely to play a significant part in investor's allocation which will not only benefit the investors but also the issuers who can align to index structures. Adequate safeguards built in, especially at the start of product lifecycle can ensure a sustainable growth & deepening of the market, & appropriate investor experience.

Mutual Fund Investments are subject to market risks, read all scheme related documents carefully.

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