Emerging Investment Trends in Passive Investing

Sundeep Sikka
Executive Director & CEO
Nippon Life India Asset Management Ltd.

It's a natural human tendency wanting to be in a position of command to be able to make your own decisions. But it may not be a good strategy when it comes to investing, even though direct equity investing seems an exciting proposition. It makes sense to delegate one's investment decisions to professionals and experts who understand the nuances of financial markets. This is where mutual funds chip in as a preferred investment option for investors. Passive investing goes a step further, where the investors tend to trust the collective wisdom of the markets instead of handing over the fund management to professional fund managers.

Passive investing finds favor due to its sheer simplicity and convenience, even though it may be utterly boring. It would be worthwhile to quote George Soros, one of the greatest investors of all times, who once said, "*If investing is entertaining, if you are having fun, you are probably not making any money. Good investing is boring.*"

Passive investing believes that the benchmark indices will closely reflect overall market conditions, as such benchmark indices are constructed using back-tested and scientific methodologies. Since markets are expected to behave rationally, passive investors are comfortable with returns that closely reflect overall market conditions. Further, index investing is a very natural progression for most of the investors as an Index is the first barometer we look at to understand how the stock markets have fared. An index has top-of-mind recall as compared to individual stocks. Most of us may not remember the performance of individual stocks over various time periods but it is more likely that we will remember how an index has performed. For e.g. it is easier to recall how the Nifty50 Index or Sensex has performed since the last fall in March 2020 but the same may not be possible for individual stocks.

While passive investing is a well-known and popular concept in developed economies, it is steadily gaining traction in India. Passive AUMs (Assets Under Management) grab a larger share in the industry AUM in the United States and other developed economies but in contrast, the AUM share of passive funds in India at the end of 2020 was 8.64%, i.e., around 2.57 lakh crores. However, it must be seen that this share had risen significantly from 1.21% around five years back in March 2015 to 8.64% in December 2020.

When selecting an investment option, investors often come across two kinds of risks, viz. systematic risk and unsystematic risk. Systematic risk refers to the risk of overall macroeconomic events impacting the investment returns. For example, the Covid-19 outbreak in March 2020 was one such risk, wherein the possibility of a significant economic impact led the entire markets to correct heavily.. In contrast, unsystematic risks refers to company specific risk i.e. risk of picking a wrong stock or a wrong fund manager Since passive funds track an index and do not leave any discretion for fund managers, unsystematic risks are eliminated automatically.

Passive schemes track an underlying index and do not involve active stock picking and constant churning, resulting in lower fund management charges. This effectively translates to relatively lower total expense ratios as compared to actively managed schemes which in effect means more of your money is invested and working for you. Thus, index funds / ETFs not only make your investment journey simpler but also more cost-effective. Warren Buffet famously said, "*Investors should remember that excitement and expenses are their enemies.*"

The increasing convenience and low-cost advantage of such funds are also helping such schemes attract more investor flows. Even if we talk solely about August 2021, ETFs attracted flows of Rs. 8,548 crores, third in rank across all the fund categories after Balanced Advantage Fund Category and Floater Funds. This is indeed reflective of the growing preference amongst investors for passive investing.

Passive investing is also gaining popularity due to the wide range of index options available. Investors can choose between equity indices like S&P BSE Sensex, NSE Nifty50, NSE Nifty Next50, etc. If the investors want to invest in debt, several debt indices like Gilt index, SDL index, etc., can be explored by the investors. Gold ETFs are also available to help the investors diversify into different asset classes. For the investors willing to have an investment exposure into international equities, there are several ETFs / Index Funds and Fund of Funds investing overseas. Such funds provide direct international exposure and act as a natural hedge against currency depreciation.. From Rs. 1,761 crores in August 2018 to Rs. 21,441 crores, the AUM of schemes investing overseas has expanded significantly. This is another encouraging trend for the investors getting inclined to a simpler and convenient investment option with granular diversification across geographies.

Mutual fund penetration has continued to be lower in India, with mutual fund AUM at around 12% of GDP

(Gross Domestic Product) as of December 31, 2020. While it had increased from around 7% in March 2011, it is still much lower than that prevailing in developed economies and other major developing economies and further lower than the global average of around 63%. The consistent inflows into such categories, along with a steady increase in the AUM, leads us to the conclusion that passive investing is here to stay for long. Passive investing is expected to fuel the next growth cycle in mutual fund penetration in the country, owing to its sheer simplicity and cost-efficiency and retail investors can definitely consider adding such funds into their investment portfolio.