Business Standard

Here's why investors should make index funds a part of their core portfolio

With active funds finding it increasingly difficult to beat their benchmarks, it is time for investors to have a significant allocation to passive strategies

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Representative image

We often hear statements such as “Localisation is the key to success in India” or “What works in the rest of the world does not work in India”. These statements are usually made by international brands across industries when they define their India-oriented business proposition and the need to be different in their approach.

The same statement — “We are different” — has also been made by active fund managers. They often speak of how India is an imperfect market, and therefore higher quality research can result in better returns for investors through active fund management. India is unlike most developed markets, they say, where investors are better off having passive funds that track the indices, as active managers tend to underperform the indices.

Index investing beats active fund management: This debate has continued for a long time in the West. One popular story pertains to Warren Buffett, one of the best-known active managers historically. In 2007, he bet that a low-cost index fund would outperform a portfolio of hedge funds. He was proven right and won $1 million in the process.

The data supporting active management in India has got weaker over a period of time with as many as 92 per cent of large-cap funds underperforming the indices over the past year, according to a study by SPIVA for the year ended December 31, 2018. The company tracks the performance of active funds versus indices. Even over ten years, in the large-cap space, the underperformance has been over 64 per cent. With mid-cap and small-cap funds as well, underperformance has been evident, though to a lower extent.

ACTIVE FUNDS ARE FACING HARD TIMES

Percentage of funds that have underperformed the benchmark

Fund category	Comparison index	One-year (%)	Three-year (%)	Five-year (%)	Ten-year (%)
Large-cap	S&P BSE 100	91.94	90.59	57.55	64.23
Mid/small-cap	S&P BSE MidSmallCap	25.58	56.52	39.68	55.26
Govt bonds	BSE India Govt Bond	81.58	71.43	88.00	96.43

Source: SPIVA India scorecard December 2018

Outperforming is proving difficult: There are multiple factors, besides lower costs, contributing to this underperformance by active fund managers. Now, fund managers have to benchmark their returns against the total return index (TRI), which was not the case earlier. A TRI shows returns of stocks accounting for capital gains as well as dividends. Increasingly, it’s proving difficult for fund managers to beat the TRI.

The recategorisation of mutual fund schemes also creates a much tighter band within which fund managers need to manage exposure across different market capitalisations.

Have index funds at core of your portfolio: Indexing is, therefore, likely to become a crucial part of prudent portfolio design for investors, with a combination of passive/index strategies becoming core to investor portfolios, and active strategies becoming satellite funds.

There are significant alternatives available in India for index strategies to become a part of investors’ portfolios. These are available in two modes of investments – index funds where both investment and redemption are made with the respective mutual fund house whose index fund you are buying. Then there are exchange-traded funds (ETFs), where investors can buy/sell the index-based product on the stock exchange, just as they buy and sell equities.

Sensex and Nifty 50: The main indices in India are those that include stocks in the top 30 or 50 by market capitalisation. The most significant amount of investor money has gone into funds and ETFs based on the Nifty 50 and the BSE Sensex. Even the Employees’ Provident Fund has invested a portion of its corpus in them. The first set of funds in this category is close to completing twenty years now.

Considering that a large number of these schemes are substantial in size, the costs of the index funds tracking these indices is among the lowest. Moreover, tracking error, an important parameter that measures how much the returns from the scheme deviate from the index, is very narrow.

Nifty Next 50: This index includes stocks that are the next 50 by market capitalisation after the top 50 largest companies which are in the Nifty 50. It essentially has stock number 51 to stock number 100 in market capitalisation, which means it is also composed of large-cap stocks. This category is believed to be an incubator for the Nifty 50 stocks. It has historically been a transition category for a large number of companies that are leaders in their respective industries today.

Sectoral index: Banking sector index products have tended to be a popular category, with ETFs in this category tracking both the broader banking indices as well as narrower indices like the PSU index. There are also ETFs based on public sector companies, such as the Bharat 22 ETF and the CPSE Index ETF that have been vehicles for disinvestment for the government.

Smart beta ETFs: This category of ETFs tracks indices that are based on certain parameters. The Nifty NV 20, for example, tracks value-oriented stocks based on quantitative parameters, including price-to-earnings, price-to-book, etc; or the Nifty Quality Low Volatility 30 that tracks specific stocks based on quality and volatility parameters. Equal-weighted index products are also available, where the weight for every stock in the portfolio is equal rather than market cap based.

Gold ETFs: While the underperformance of gold ETFs has reduced the popularity of this category, it continues to be an excellent way to take exposure to gold as a part of asset allocation.

International index exposure: For geographical diversification, which is a critical part of any robust asset allocation strategy, investors could consider the use of an ETF available in India that tracks the NASDAQ 100 index, giving access to large global businesses, some of which belong to industries that are not available to Indian investors domestically.

It’s time to make indexing a core part of your portfolio, and let passive and active strategies co-exist. This can be done using a mix of index funds and ETFs that works for you.

The writer is the founder of Plan Ahead Wealth Advisors, a SEBI registered investment advisory firm.