Cheaper index funds are not always better

Index funds with a good track record and low tracking error are safe bets

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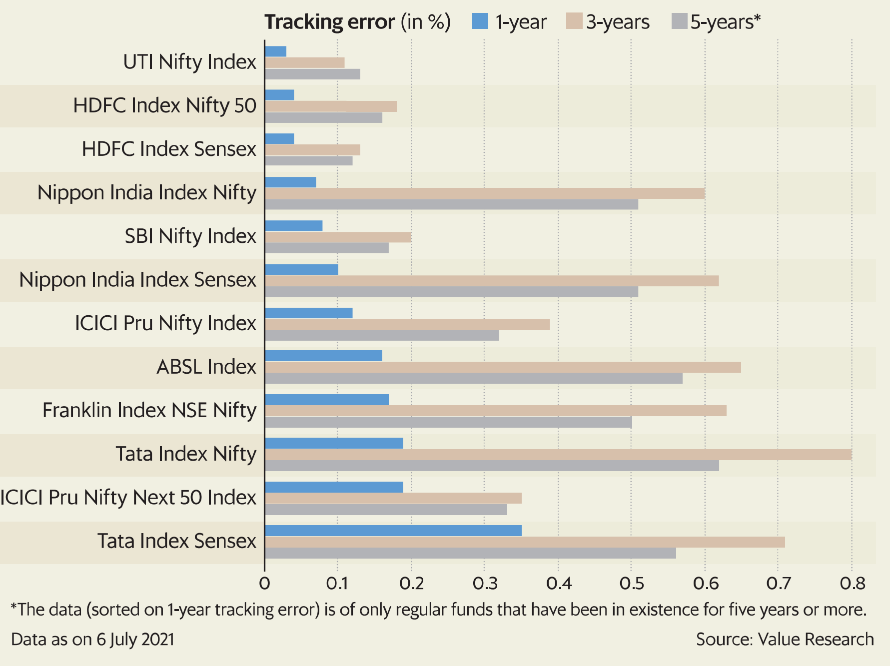
On track

Index funds with low tracking error



*The data (sorted on 1-year tracking error) is of only regular funds that have been in existence for five years or more.

Data as on 6 July 2021

Source: Value Research

PARAS JAIN/MINT

Index funds are synonymous with low-cost. When ace investor Warren Buffett talked about them, he used the term "low-cost" when he mentioned index funds. Recently, Sachin Bansal-backed Navi Mutual Fund launched the Nifty 50 Index Fund. One key highlight of the fund is that it will charge 0.06% as the total expense ratio.

Investors must look at the expense ratio of an index fund when choosing one. But they should not entirely base their investment decision on costs associated with an index fund. A fund with a lower expense ratio may not necessarily be the best one.

"Investors need to define what low-cost means for them. We look at the expense ratio of passive funds in relation to actively managed schemes. Therefore, a fund that charges an expense ratio of 0.06% or 0.25% are both low costs," said Suresh Sadagopan, founder of Ladder 7 Financial Advisories and a Sebi-registered investment adviser (Sebi-RIA).

Let us look at the parameters that RIAs use when they recommend index funds to their clients.

Tracking error: The difference in the performance of an index fund and the underlying index is tracking error. Suppose the Nifty 50 index gained 5% last month and an index fund tracking it gave 4.5% returns. The difference in the performance is the tracking error.

It's the most vital parameter that RIAs use in selecting index funds, and they prefer schemes with low tracking errors.

A high tracking error can happen due to different reasons, including when a fund is not closely tracking the underlying index and if there's redemption pressure.

Fund size: Most RIAs look at index funds of ₹100 crore or more. They keep smaller funds out for various reasons. Any significant inflow or outflow in a small fund can lead to a high tracking error. Some fear that fund houses can discontinue the fund or merge it with another if it remains small for some years.

Inception: When looking at the track record of an index fund, most RIAs prefer schemes in existence for at least three years. It allows them to check the tracking error over different periods.

Index fund NFOs: In the recent past, there has been a shift towards passive funds. More investors are looking at index funds as most actively managed large-cap schemes have not been able to beat their benchmarks.

As the interest in passive investment is on the rise, some new fund houses want to capitalize on the opportunity. Zerodha, India's biggest brokerage, has applied for a mutual fund licence with the markets regulator. The broking house intends to start an asset management company that will focus only on passive investing.

> **High tracking error can happen for reasons including when a fund is not closely tracking the underlying index**

"India is at a nascent stage of index investing. There are index funds only in limited categories. Suppose someone wants to invest in the Nifty 500 index. In that case, there's probably only one fund house that offers an index fund in this category," said Harsh Roongta, founder, Fee-Only Investment Advisers, a Sebi-registered investment advisory firm.

According to Roongta, the new fund houses can make index funds more competitive and lead to innovations.

So, should investors look at new fund offers (NFOs) of index funds?

In theory, index fund NFOs are different from those of actively managed funds. As index funds mimic the underlying index, investors may not need to wait and look at their track record.

"That's partially true. In an index fund, an investor should look at the tracking error of funds over the years before choosing one," said Vishal Dhawan, founder, Plan Ahead Wealth Advisors, a Sebi-registered investment advisory firm.

According to Dhawan, if the NFO is a me-too fund—for which investors have comparable schemes—it's better to stick to index funds with a track record.

However, if the NFO is in a new category altogether, for which there are no alternative funds, investors can evaluate them, provided they want to take exposure to the specific category or index. Stick to an index fund that has been around for at least three years and has a lower tracking error.