P E R S P E C T I V E

Exchange Traded Funds - Its Growth & Challenges in India.

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Exchange Traded Funds are essentially Index Funds that are listed and traded on exchanges like stocks. Until the development of ETFs, this was not possible before. Globally, ETFs have opened a whole new panorama of investment opportunities to Retail as well as Institutional Money Managers. They enable investors to gain broad exposure to entire stock markets in different Countries and specific sectors with relative ease, on a real-time basis and at a lower cost than many other forms of investing.

An ETF is a basket of stocks that reflects the composition of an Index, like S&P CNX Nifty or BSE Sensex. The ETFs trading value is based on the net asset value of the underlying stocks that it represents. Think of it as a Mutual Fund that you can buy and sell in real-time at a price those changes throughout the day.

As it tracks a Benchmark Index, the return expectation is the same as that of the Index. For example, if for a particular period, say from 1st Jan to 31st of March the ROI on Nifty is 10%, then the NAV of the ETF that tracks Nifty should also be around 10%. The minor difference in return between the NAV and the Benchmark Indices could be because of the fact that there would be some cost involved in managing the ETF. This is commonly referred as Tracking error (as this term is referred later)

The objective and the characteristics of ETF are similar to Index Funds managed by Asset Management Companies. The difference between these two Asset Classes stems from the fact that ETF are traded on the Stock Exchanges and hence investor can derive benefits of trade in ETF just like any ordinary stocks. So, by owning an ETF, an investor get the diversification of an index fund as well as the ability to sell short, buy on margin and purchase as little as one share. Another advantage is that the expense ratios for most ETFs are lower than those of the average mutual fund and are equally tax efficient.

Because of its distinct advantages, ETF has emerged as one of the most popular Asset Classes amongst the Investor community across globe, including India.

Advantage and Disadvantage of Investing in ETF

Benefits.

- Can easily be bought / sold like any other stock on the exchange through terminals across the country.
- Can be bought / sold anytime during market hours at a price close to the actual NAV of the Scheme.
- No separate form filling. Just a phone call to your broker or a click on the net
- Ability to put limit orders
- Minimum investment is one unit.
- Enjoy flexibility of a stock and diversification of index fund
- Expense Ratio is lower. Hence low cost invest, even lower than the index funds
- Provides arbitrage between Futures and Cash Market
- For a better insight, refer to the tables given below.

Table 1. (ETF, STOCKS AND MF)

	Functionality	ETF	STOCK	MF
1	Real Time Pricing	√	√	×
2	Ability to put limit orders	√	√	×
3	On line Trade through Exchange	√	√	×
4	Arbitrage possible between Future and cash market.	√	√	×
5	Diversification possible with a single unit purchase	√	×	√
6	Return at Par with the market/index	√	×	×
7	Paper less investing	√	√	√
8	Exit Load	×	×	√
9	Brokerage	√	√	×

Involves brokerage as against for MF.

Table-2. (ETF VS INDEX FUND)

Attribute	ETFs	Traditional Open Ended Index Funds
Traded throughout the day	Yes	No
Low Expense Ratio	Yes	No
Trade at any brokerage firm	Yes	No
Hedging Tool	Yes	No
Ability to lend units	Yes	No
Tracking	Best	Average
NAV	Indicative Real time	Daily
Liquidity	Fund / Stock market	Fund
Structure	Insulates long term investor from short term trading activity	Does not insulate long term investors from short term investor activity

Disadvantages

- Underlying volatility – ETFs passively track other financial instruments, which can be liquid or volatile. Usually market indexes are less volatile than specific sectors or industries. Similarly international ETFs which track indexes of countries / regions with strong fundamentals are less volatile.
- ETF liquidity – Although the liquidity of ETFs match liquidity of tracking index, their own trading volume is also a factor worth noticing. With coming of new types of ETFs to the market, now there are quite a few not-so-liquid ETFs having large differences between ask and bid prices.
- Capital gains distribution – most ETF firms invest capital gains to the market, which is often the right thing to do. ETFs which distribute capital gains to ETF holders are making the shareholders qualify for capital gains tax.
- Dollar cost averaging – DCA is a simple but effective way of building a big portfolio. But the costs involved in ETF trading makes DCA less-effective (unless trading through a discount broker).
- SIP investing - SIP in ETF is not convenient as you have to place a fresh order every month
- Also SIP may prove expensive as compared to a no-load, low-expense index funds as you have to pay brokerage every time you buy & sell
- Because ETFs are conveniently tradable, people tend to trade more in ETFs as compared to conventional funds. This unnecessarily pushes up the costs.
- Dividend reinvestment - You can't automatically re-invest your dividends. Secondly, you may have to pay brokerage to reinvest dividends in ETF, whereas dividend reinvestment in MFs is automatic and with no entry-load
- Comparatively lower liquidity as the market has still not caught up on the concept

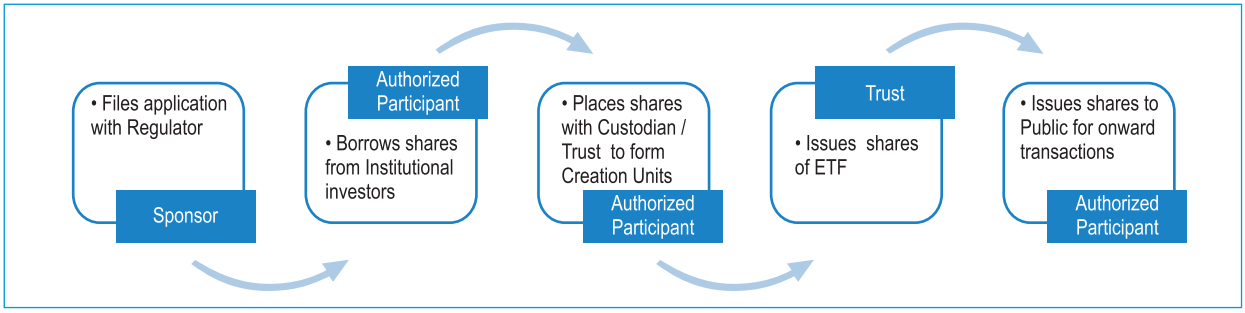
Operation Aspects - Buying and Selling ETF

- ETFs can either be purchased on the Exchange or directly with the Fund. The Fund creates / redeems units only in predefined lot sizes in exchange for a predefined underlying portfolio basket. Once the underlying portfolio basket is deposited with the Fund together with a cash component, the investor is allotted the units.

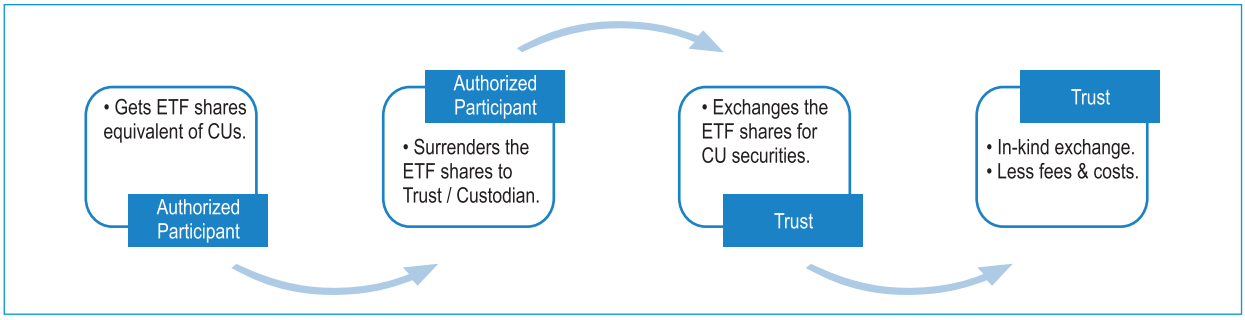
  This is in-kind creation / redemption of units, unique to ETFs.

  Alternatively, investors can follow the "Cash Subscription" route in which they can pay cash directly to the Fund for purchasing the underlying portfolio.
- For a retail investor to buy a unit of ETF from the secondary market, it is similar to buying or selling a particular stock from the stock market. They can directly buy / sell from exchange, through their designate Broker, the ETF units gets credit / debited from their Depository account.
- Given below is the diagram to further elaborate the difference between creation of units in MF and in ETF.

A. Process Diagram for creation of ETF units.



B. Redemption of ETF.



Growth of ETF

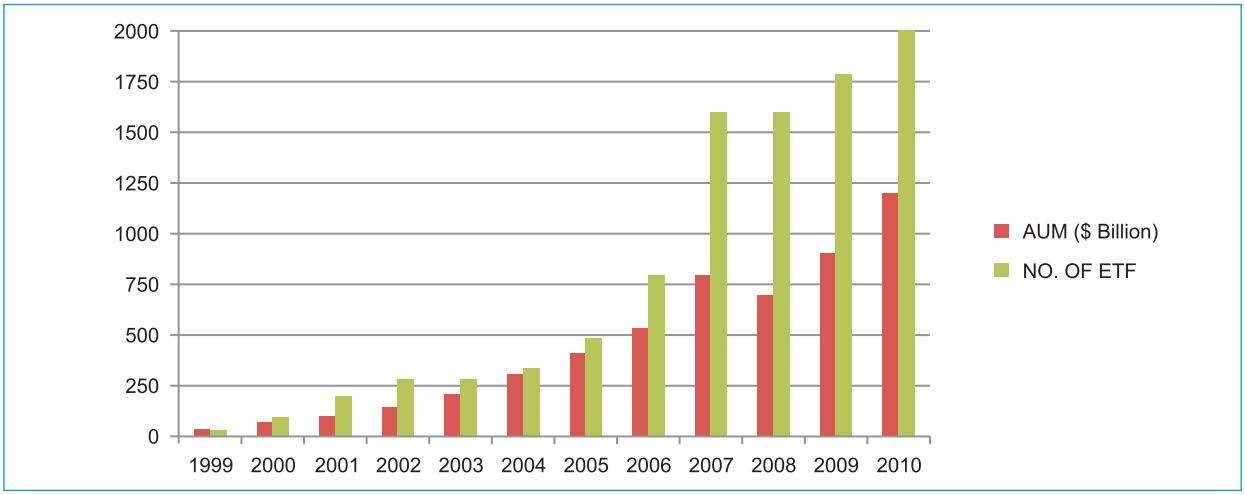
A Brief on Global ETF Industry.

They first came into existence in the USA in 1993. It took several years for them to attract public interest. But once they did, the volumes took off with a vengeance. As of September 2010, there were 916 ETFs in the U.S., with $882 billion in assets. About 60% of trading volumes on the American Stock Exchange are from ETFs. The most popular ETFs are QQQs (Cubes) based on the Nasdaq-100 Index, SPDRs (Spiders) based on the S&P 500 Index, iSHARES based on MSCI Indices and TRAHK (Tracks) based on the Hang Seng Index. The average daily trading volume in QQQ is around 89 million shares.

As of October 2011, in United States, ETFs' assets under management have grown significantly since August 2007 — from $400 billion to $1 trillion with total number of listed ETF are around 1300.

Exchange Traded Funds or ETFs have revolutionized the Investment Industry in recent times due to their simplicity, low costs and ease of use. The US Market has seen a massive growth in the usage of this Financial Instrument with a mind boggling variety of ETFs catering to almost every asset class ranging from equities, bonds, currencies commodities and even derivatives. The low cost of the ETFs compared to the mutual funds and their passive form has attracted investors in huge droves. A similar surge is expected in the Indian Market as well.

Growth of Global ETF Industry (Chart-1)



Growth of Domestic ETF Industry

India's journey started with Benchmark launching the first ETF called Nifty BeEs in 2002. Since then fund has come a long way with AUM rising to 587 Crs from less than Rs. 10 Crs mobilized through NFO. Today there are 32 ETFs in MF industry of which 11 are in Gold category and balance 21 in other category. The total AUM managed under Indian ETF umbrella is close to 10,838 Crs as of Oct 2011 of which 83% belongs to Gold ETFs. With the arrival of Gold ETFs the segment has acquired enhanced interest from investing community and today it has more than 5.54 lac investor (4.28 lac in Gold ETFs and 1.25 lac in other ETFs) in overall ETFs segment. The investor spread is across Corporate, HNIs, Retail and Banks / FIs.

We have ETFs tracking various Indices, e.g ; Bank Nifty, Sharia Index, Infra Index, Liquid BeES and the spot gold. Due to surge in the Gold Prices globally, and the yields on the gold ETFs, it has generated lot of interest amongst the investing community. As explained above, as a result, the AUM of the Gold ETF grew by leaps and bounds and is largest in the segment.

Goldman Sachs (Took over Benchmark AMC in July 2011) is most dominant player in the industry having a total of 6 schemes.

Due to the surge in the number of GOLD ETF, I have categorized the ETF into two - 1. ETF-Others and 2. ETF-Gold. As such, there are three graphs plotted – 1. ETF (TOTAL), 2. ETF-OTH and 3. ETF-GOLD.

Have a look at the Graphs.

Chart-2 (Overall Growth of ETF in India, as of October 2011)

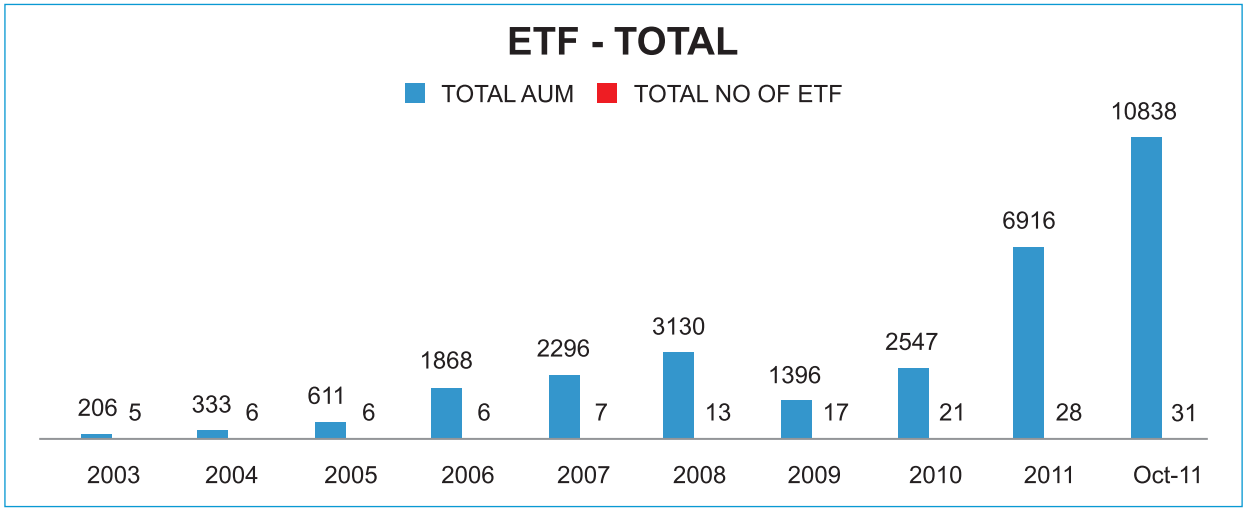


Chart-3 (Growth of ETF in India, excluding the Gold ETF, as of March 2011)

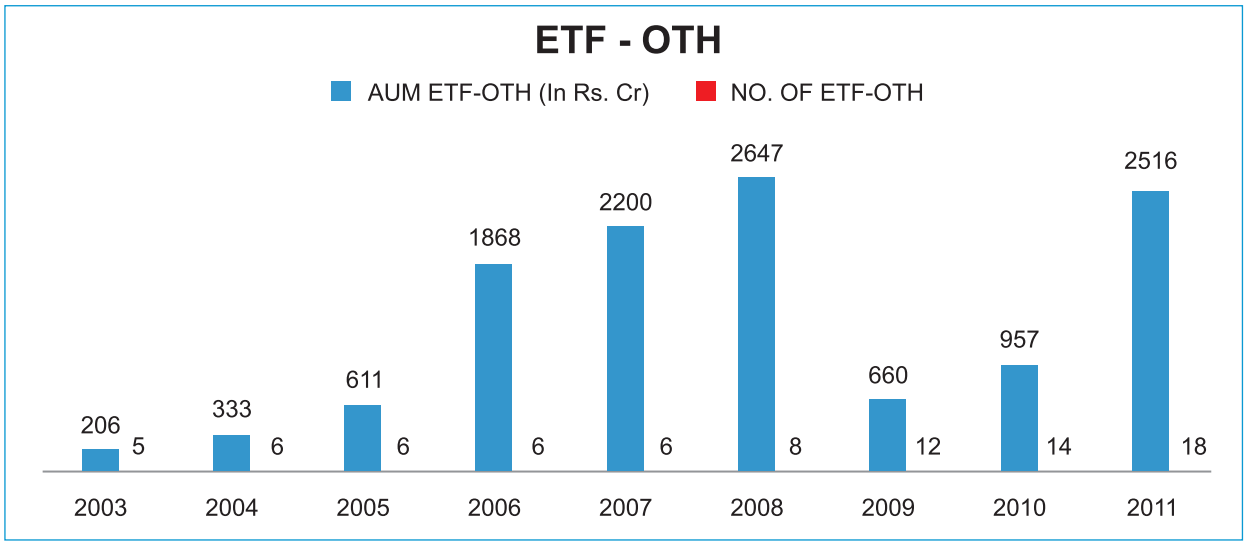
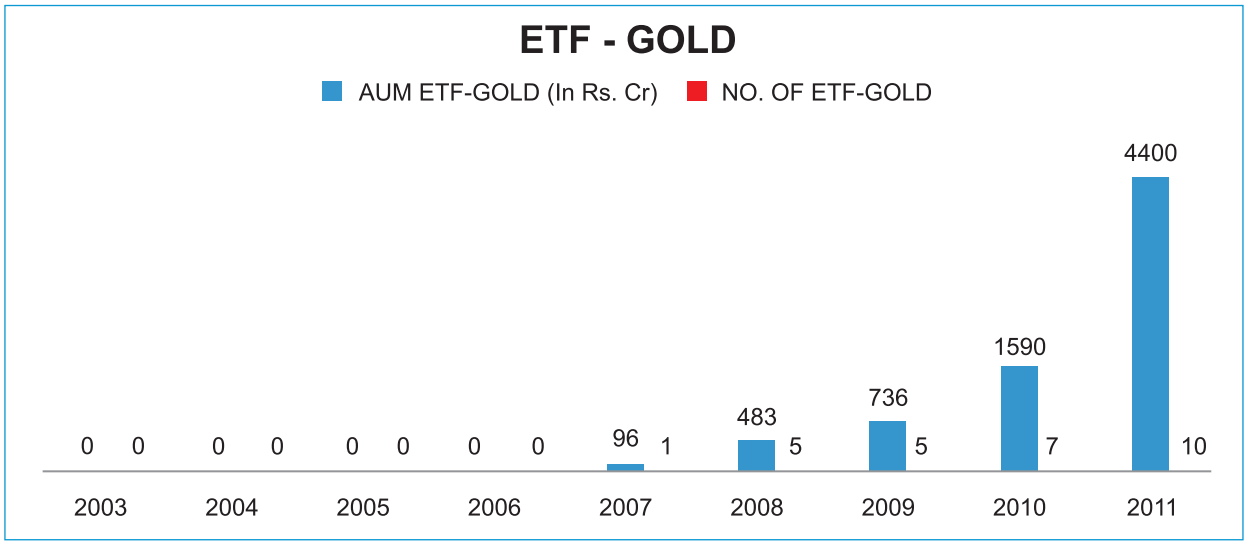


Chart-4 (Growth of ETF-Gold in India, as of March 2011)



Important Observations are Highlighted Below.

- There is a consistent overall growth of AUM in ETF. So, this can be construed that there is a demand of ETF in India and people have accepted ETFs as one of the most important investment destination.

- During the period 2008-09, there was a downfall in the AUM for the ETF-OTH. This is the time when the market faced the slump during the subprime crisis, and the Global and India market saw an unprecedented fall. Since most of the ETF tracking the Nifty and other equity Benchmark indices, the returns on ETF has also plummeted. This lead to widespread redemption in ETF and hence considerable fall in the AUM of ETF.

- However, there is fabulous growth in the GOLD ETFs. The First GOLD-ETF was launched by Benchmark in the year 2007, followed by UTI AMC.

    - The returns on ETF track the return of the Benchmark Indices. There is a drop in the returns amidst volatility on the various underlying like the NIFTY, PSU BANK Index, Bank Nifty etc. At the same time the "spot gold" has been outperforming other indices. Due to firming of the Gold prices, this index has given phenomenal return during the period. This justifies the interest among the investor community for the GOLD ETF.

    - The fall and rise in the AUM, normally tracks the return of a particular Fund/Scheme. It is quite understandable that the Fund that performs better attracts more investor and the one with not so good performance, loses out. In case of ETF, it is more prominent.

Challenges

ETF has emerged as one of the important investment product. However, despite the early promise, ETFs haven't really taken off in India so far. According to the Association of Mutual Funds of India (AMFI) data, ETFs comprise of only 0.3% of the total industry assets. In comparison, ETFs comprise about 9% of the MF industry in the US. It is going to be a long journey for ETF to become the most preferred investment class. Some of the important limitation that hurting the growth of ETF are given below.

- While the MF industry works on a distribution model, ETFs are sold by stock brokers, not distributors who find more potential in their earnings in selling equity stocks to customers and getting them to churn. It will take time to educate brokers on ETF's benefits.

- Indian stock market indices see frequent churn of indices going in and out. "Such churn forces the fund manager to sell the scrip that moves out of the index and buy the scrip that enters the index. Here, the ETF fund manager himself rebalances the portfolio; the scheme bears the cost.

- We still have lots of stocks in the stock market, and an average Fund Manager, could easily pick stocks that outperform the broader Index. Hence the whole concept of index tracked Funds are not enthusing the investor in India.

- ETF can be as volatile as a normal security listed on the Exchange. We will try to understand these phenomena through an example.

  - Economic Times recently published news about UTI SUNDER, an ETF tracking the NIFTY, whereby the Fund House has cautioned the investor about the possible manipulation of the share price of this ETF. As per the news, the shares have jumped 300% in the past three months. The benchmark Nifty, which the ETF is supposed to track, has fallen around 5% during the same period. In case of SUNDER (S&P CNX Nifty UTI Notional Depository Receipts Scheme), the NAV has correctly tracked the Benchmark Nifty (underlying). See the table below :

SUNDER - Fund Performance as of 24th November 2011

Period	NAV Growth	Nifty Return (Index %)
1 Year	-15.83	-18.86
2 Year	-0.93	-2.79
3 Year	22.55	21.58
5 Year	5.45	4.91
7 Year	15.53	15.29

  - It is clear from the above table that SUNDER has tracked the index with minimal tracking error. However the market price of the ETF has been very volatile. At certain period, the market price soared by over 250% also. Logically, the market price of an ETFs should be in the tight range and should hover around the NAV that Fund House publish on a daily basis, (plus – minus the current day underlying index movement). This is for the simple reason that any redemption from the Fund House (issuer) would fetch the value proportional to the NAV. To elaborate this further, suppose the market price of the ETF is 150% more than the NAV of the Fund and tomorrow the Fund got de-listed, then the holder of the ETF share will only get the current NAV value from the Fund House. But typically, market has nothing to do with the NAV. The price is derived simply on the demand and supply dynamics. As long as the bid and offer rate are matched, there will be a deal. However, since ETFs are just a mirror image of the underlying index, the difference of this nature definitely raises doubts. No denying of the fact that certain cartel is busy speculating the price of SUNDER. Hence, the ETF price can also be rigged in the market place and small/retail investor may fall prey to this speculative activity. As such, the market price of the ETF could be misleading.

Conclusion

ETF has definitely made a mark on the Indian Investment panorama and has introduced a new investment opportunity for the investor. As the market matures, we are going to see a lot of action on the ETF horizon, for sure.

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4. Benchmark AMC website

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