# GROWTH OF EXCHANGE TRADED FUNDS (ETFS) IN INDIA: FACTORS DRIVING THE SURGE

(BASED ON SURVEY OF INVESTORS)


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(Under the guidance of Ms. Janavi Nagrecha, Chairman, IIFL Securities)

**Objective of the study**

Exchange traded fund (ETF)s have witnessed strong growth globally and of late in India as well. The paper studies the growth in ETFs and analyses reasons for investors' increasing preference based on a survey of 100 investors in Mumbai.

## Growth of Exchange Traded Funds (ETFs) in India: Factors Driving the Surge

### Summary

The research project was done under the guidance of Ms Janavi Nagrecha Vice President Investment in IIFL Securities Ltd. The project involved secondary data on websites, industry associations, company's internal databases that were made available, interviews with Relationship Managers and finally a survey of a sample of actual investors.

Exchange Traded Funds (ETFs) have gained significant traction in India's investment landscape. These financial instruments offer a combination of diversification akin to mutual funds and the flexibility of stocks, making them increasingly popular among investors. Globally, investors' growing preference for ETFs can be attributed lower expense ratio, easy access to diversified portfolios, tax-efficiency due to their unique structure, transparency and easy access through online platforms. In India, ETFs started with launch of the NiftyBeeS and then gold ETFs. The government divestments through ETFs raised investor awareness. Today, ETF AUM, ₹5.61trillion as of June 30, 2023—tripling in just there years from June 2020.

95% of surveyed investors agreed that the trend of investing through ETFs is on the rise, reflecting the growing popularity of these instruments. 70% of respondents invested for lower cost structure and 25% in expectation of better returns. Only 15% allocated over 50% of their portfolios to ETFs, and most (52%) had investment horizon of 5 years and more. Majority of investors got to know about ETF from social media (42%). The insights from the survey of investors as well as interviews with industry experts indicate to continued rapid growth and bright prospects of ETFs as vehicle for individual investors in India.

### What is an Exchange Traded Fund (ETF)?

Exchange Traded Funds or ETFs can be thought of as an investment fund that has the diversification benefit of mutual funds and can be traded like a stock that is bought and sold through brokerage accounts and have continuous pricing and liquidity throughout the day. An ETF can be structured to track anything from the price of an individual commodity to a large and diverse collection of securities. ETFs typically have lower expense ratios and broker commissions compared to buying stocks individually or buying a regular mutual fund. ETFs are considered a safer product for risk averse and first-time investors who want market linked returns. (Chen, 2023).

### Evolution of ETFs – a global perspective

Exchange traded funds are relatively a new phenomenon. They started in 1990s, with First American ETF (S&P 500 SDPR) in 1993. This was followed by Bloomberg Barclays TIPS fund in 1996. Vanguard, now one of leading global players in ETF, started offering ETFs only in 2001. Since then, there has been a flood of ETFs in the global markets. They gained popularity as they provided access to passive, indexed funds to individual investors. Currently in the US alone, ETFs have assets of over $6.5 trillion. As ETFs grew in assets and popularity they are now used by all types of investor and trader around the world. ETFs now represent everything from broad market indices to niche sectors or alternative asset classes. (Simpson, 2022).

From one fund in 1993, the ETF market grew to 102 funds by 2002, and nearly 1,000 by the end of 2009. According to research firm ETFGI, now there were more than 7,100 ETFs trading globally. (Santiago Guzman, 2022).

### Global investment in ETFs has grown exponentially in the last two decades from $0.2 trillion to $9.94 trillion

| World-wide investment in ETFs (USD Trillions) | Year | World-wide investment in ETFs (USD Trillions) | Year |
|---|---|---|---|
| 0.2 | 2003 | 2.28 | 2013 |
| 0.28 | 2004 | 2.67 | 2014 |
| 0.42 | 2005 | 2.9 | 2015 |
| 0.58 | 2006 | 3.42 | 2016 |
| 0.87 | 2007 | 4.69 | 2017 |
| 0.72 | 2008 | 4.68 | 2018 |
| 1.04 | 2009 | 6.19 | 2019 |
| 1.31 | 2010 | 7.74 | 2020 |
| 1.35 | 2011 | 9.94 | 2021 |
| 1.77 | 2012 | | |

*(Source: Reuters via Refinitiv Lipper 2022)*

### Why people are moving from active funds to ETFs?

The increased investor appetite for ETFs is because of many reasons. Primary reason is lower expense ratio. It has the advantage of access to many stocks across various industries and also better risk managed due to the diversification. ETFs allow investors to invest in focused strategies targeting specific industries or indices. Many investors chose ETF as they don't want to invest in the concentrated risk associated with a stock and higher fees associated with a regular mutual fund. Also, ETFs are the most tax efficient compared to stocks and mutual funds. (Derek Horstmeyer, 2023) (schwab, n.d.) (etf.com, n.d.).

### Here is a list of reasons due to which the share of ETFs have been increasing in mutual fund investments

1. Cost-Effective: ETFs generally have lower expense ratios compared to actively managed mutual funds. They can be an inexpensive way to achieve a diversified portfolio, as they often track market indices.

2. Liquidity: ETFs can be bought and sold on stock exchanges throughout the trading day, just like individual stocks. This allows for more flexibility compared to mutual funds, which are typically priced once a day at the close of trading.

3. Transparency: ETFs disclose their holdings on a daily basis, whereas mutual funds typically do so on a quarterly basis. This daily disclosure provides more information and transparency to investors.

4. Tax Efficiency: ETFs tend to be more tax-efficient than mutual funds due to their unique structure. When an investor redeems shares in a mutual fund, the fund may have to sell securities to meet the redemption, potentially triggering capital gains. In contrast, ETFs use in-kind redemptions, which can help minimize capital gains distributions.

5. Innovation and Variety: ETFs offer exposure to various asset classes, sectors, geographic regions, and investment strategies, including thematic investing (e.g., technology, environmental, social, and governance (ESG) investing). This wide range of options allows investors to easily tailor their portfolios to their specific investment goals and risk tolerance.

6. Ease of Access: With the growing popularity of online trading platforms, it has become easier for retail investors to access ETFs. These platforms often provide commission-free trading for ETFs, making them an attractive option for cost-conscious investors.

7. Passive Investing Trend: The rise of passive investing has contributed to the growth of ETFs. Many investors prefer passively managed ETFs, which track a specific index, over actively managed mutual funds due to their lower costs and ease of access.

## Indian ETF industry growth and potential

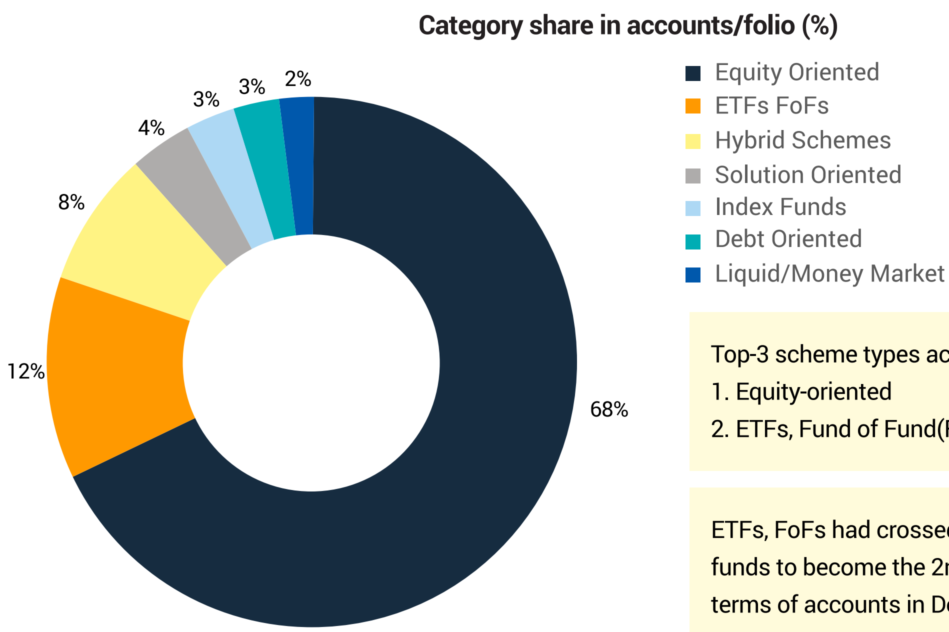
India's first ETF, the NiftyBeeS was launched in 2001. In the initial years of Indian ETFindustry, gold ETFs dominated the AUM, until in the Union Budget 2013 included ETFs as an eligible asset in the pension fund universe and the securities transaction taxes were reduced to make it in line with mutual funds. The government divestments in public sector enterprises through the ETF route, provided a major fillip in terms of investor awareness, as well as assets. As per recent data from Association of Mutual Funds in India the ETF industry assets under management stood at Rs 5.61 lac crore as on June 30, three times the size in June 2020. (Shivanath Ramachandran, 2019) (NSE, 2023).

## Exchange Traded Funds (ETFs) have grown rapidly in the last two decades


The chart shows the Nifty TR index since 2001. The major events around ETFs are represented as callouts.

*(Source: CFA Society India)*

## ETF investments is predominantly in equity oriented schemes

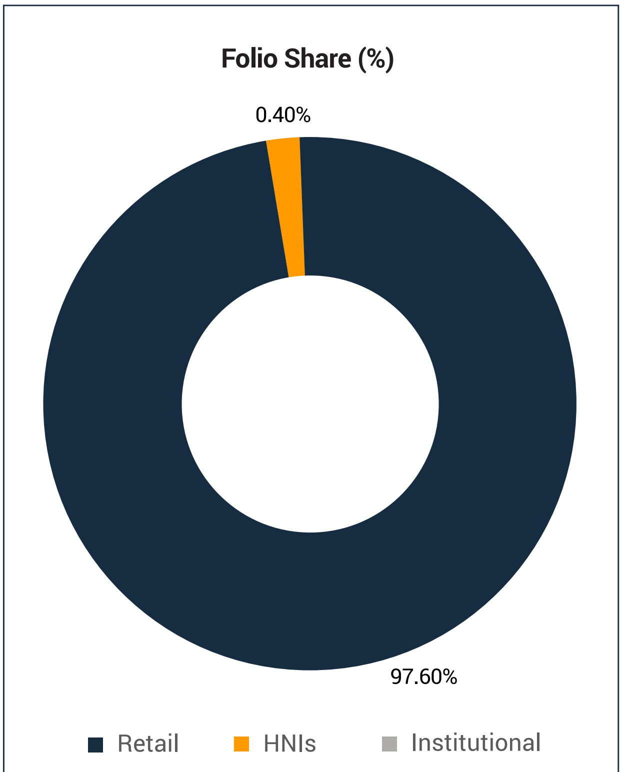



Top-3 scheme types across accounts are:
1. Equity-oriented
2. ETFs, Fund of Fund(FoF)s

ETFs, FoFs had crossed hybrid and debt-oriented funds to become the 2nd largest category in terms of accounts in December 2022

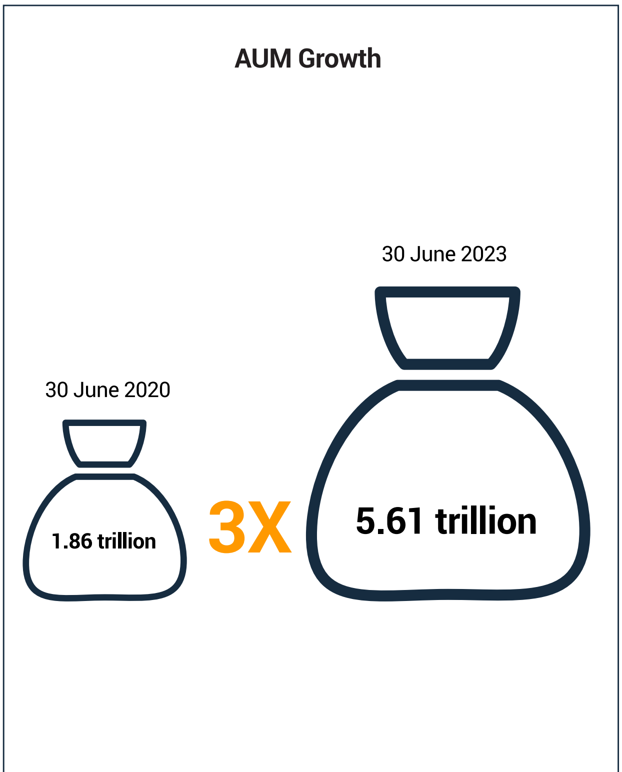
*Source: Amfi, data as on 30 June 2023*

## Retail investors are the key ETF investors




Over 97% of ETF, FoF folios belonged to retail investors and about 2% belonged to high-net-worth investors (HNIs). Folios of institutional investors were under 1%.

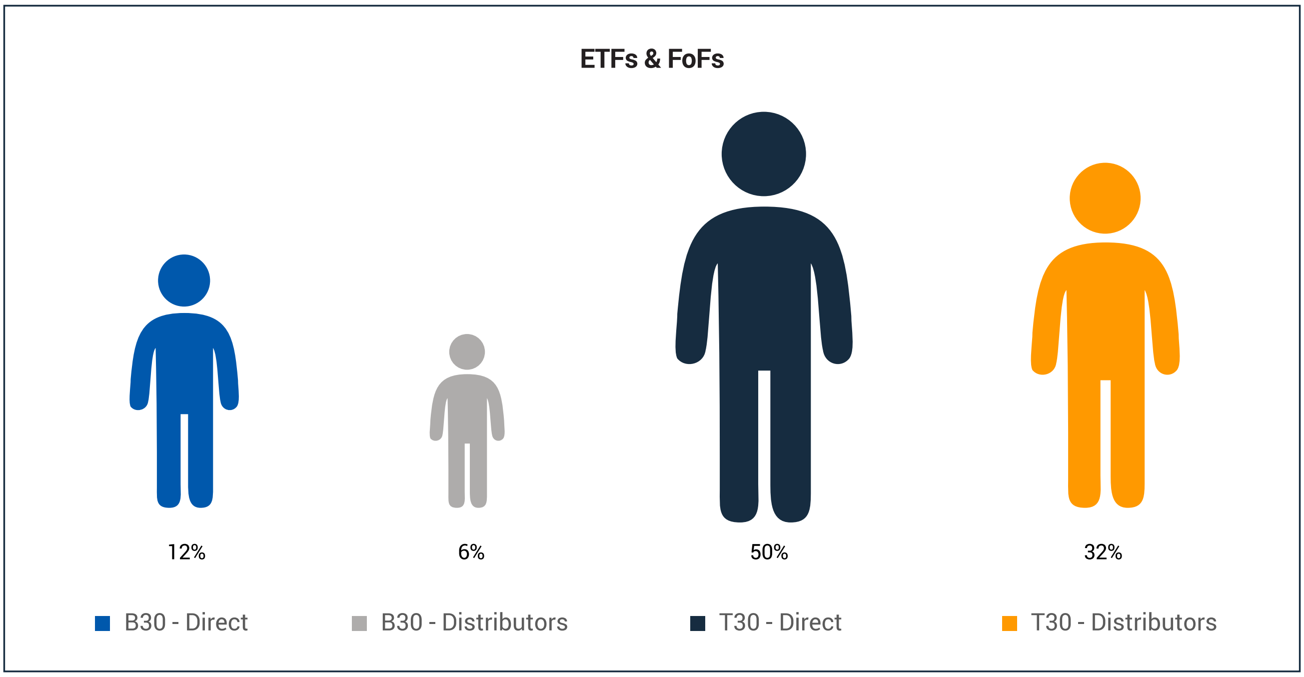
## ETF assets grown 3x in last three years



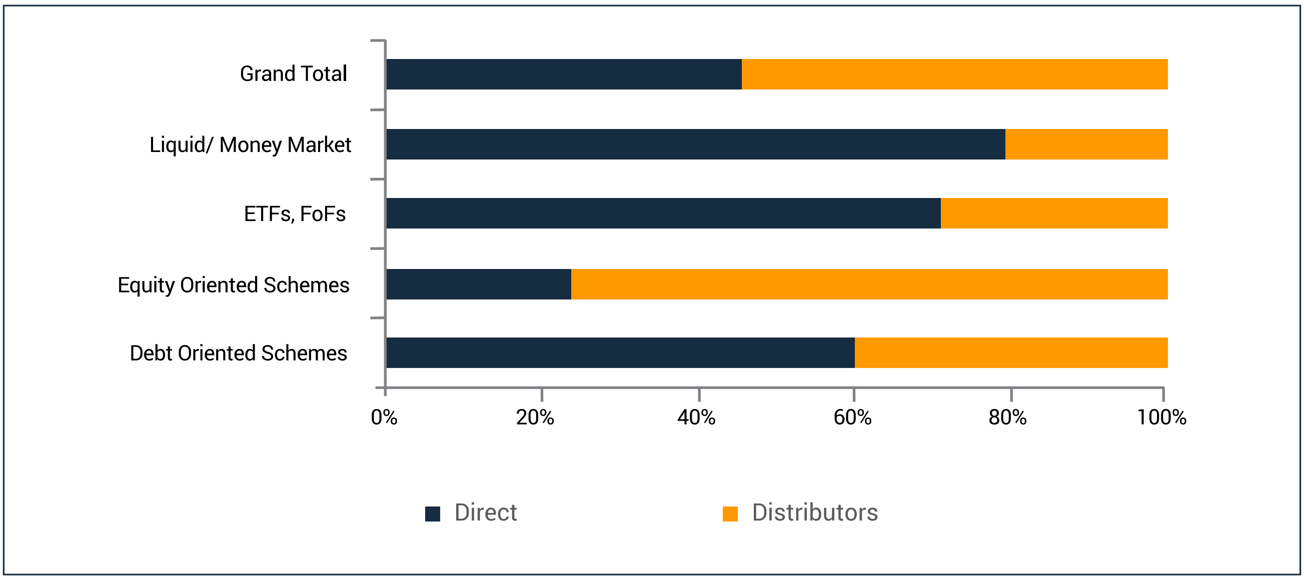

In just three years, the assets under management (AUM) of ETFs has grown three-times, from ₹1.86 trillion (as on 30 June 2020) to ₹5.61 trillion (as on 30 June 2023).

*Source: Amfi, data as on 30 June, 2023*

## How individual investors invest in ETFs/FoFs



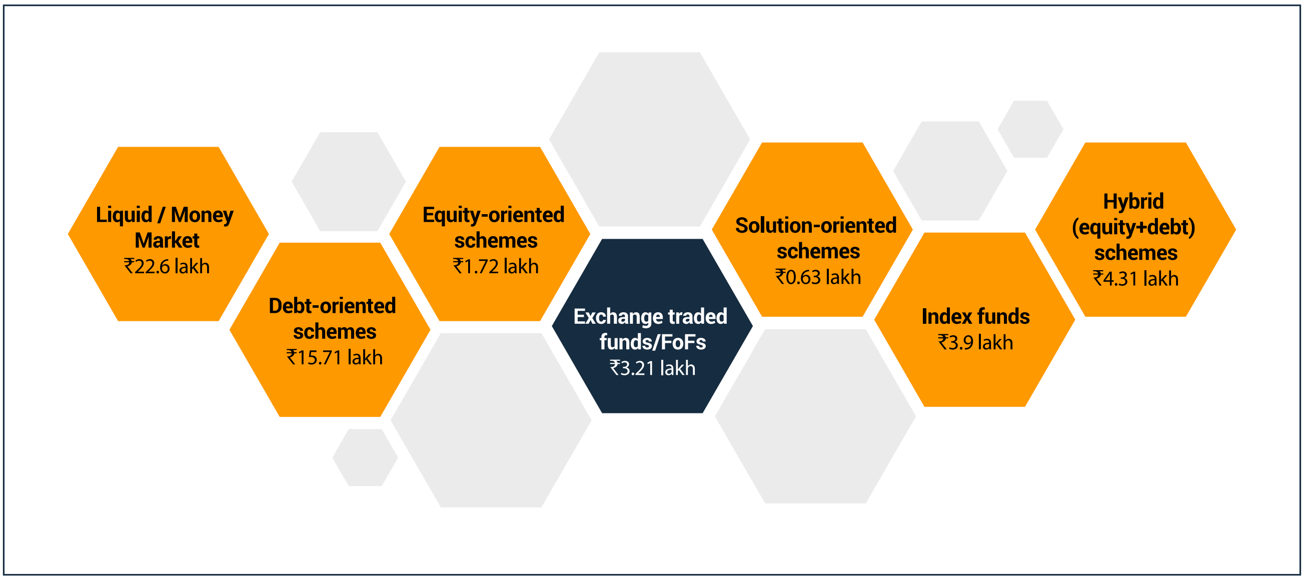
## About 50% of ETF investment is from Top 30 cities and direct route




*Source: Amfi, as on 31 July 2023, Individual investors here include HNIs*

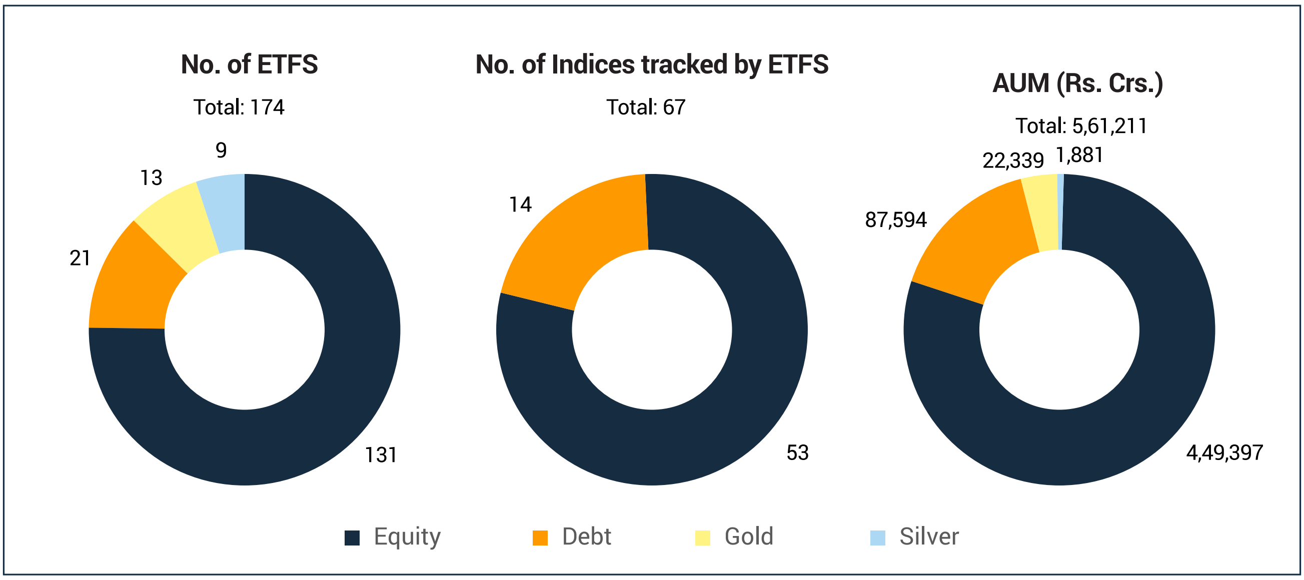
ETFs and fund of funds are largely popular among individual investors opting for direct plans of mutual funds. They either opt for these funds on their own or in some cases are guided by registered investment advisors.

## Average investment size of ETF is higher than active equity mutual funds




Across the mutual fund industry, the average ticket size is ₹2.98 lakh. The average ticket size in ETFs/FoFs is higher at the average ticket size at ₹3.21 lakh.

## Equities dominate number of schemes and investment corpus of ETFs in India




*Source: NSE, as on 30 June 2023*

Equity ETF is most popular category. A wide range of equity indices are tracked by multiple ETFs. Investors can choose from several strategies and market caps – large-, mid- and small-cap, as well as debt and commodities.

| Nifty-50 | AUM |
|---|---|
| SBI Nifty 50 ETF | 1,61,599 |
| UTI Nifty 50 ETF | 42,252 |
| Nippon India ETF Nifty 50 BeES | 12,768 |

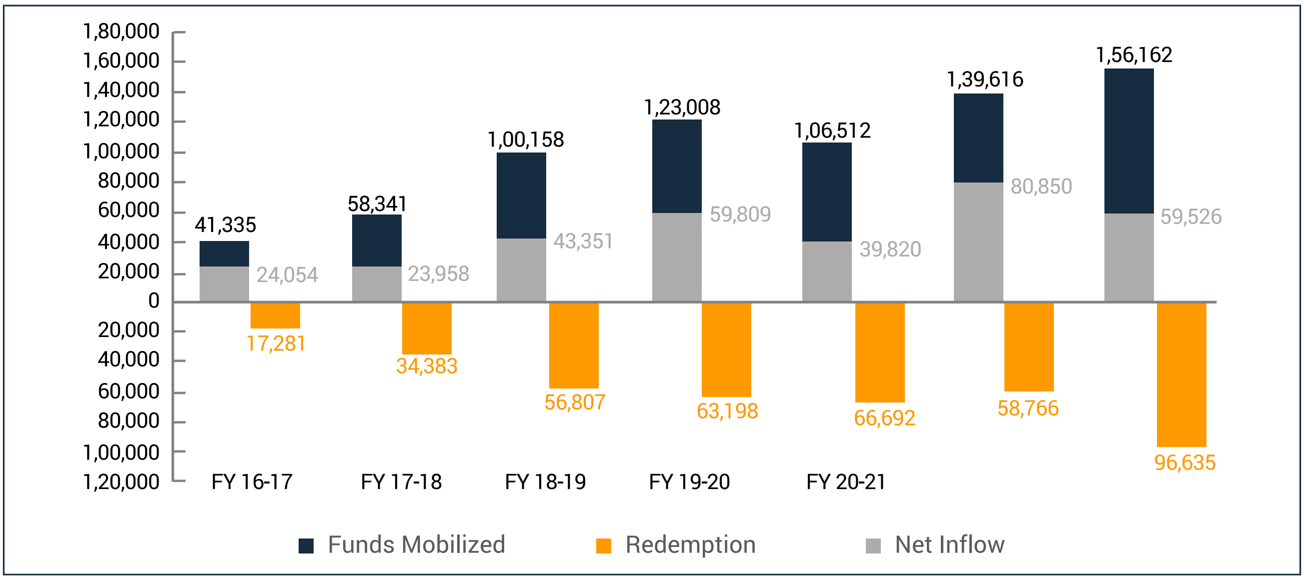
| Nifty-50 | AUM |
|---|---|
| BHARAT Bond ETF April 2030 | 17,745 |
| BHARAT Bond ETF April 2031 | 12,945 |
| BHARAT Bond ETF April 2025 | 12,406 |
| BHARAT Bond ETF April 2032 | 10,394 |
| BHARAT Bond ETF April 2033 | 5,320 |

| Nifty-50 | AUM |
|---|---|
| Nippon India ETF Nifty Bank BeES | 5,995 |
| Kotak Nifty Bank ETF | 4,491 |
| SBI Nifty Bank ETF | 4,317 |

*Source: NSE, as on 30 June 2023*

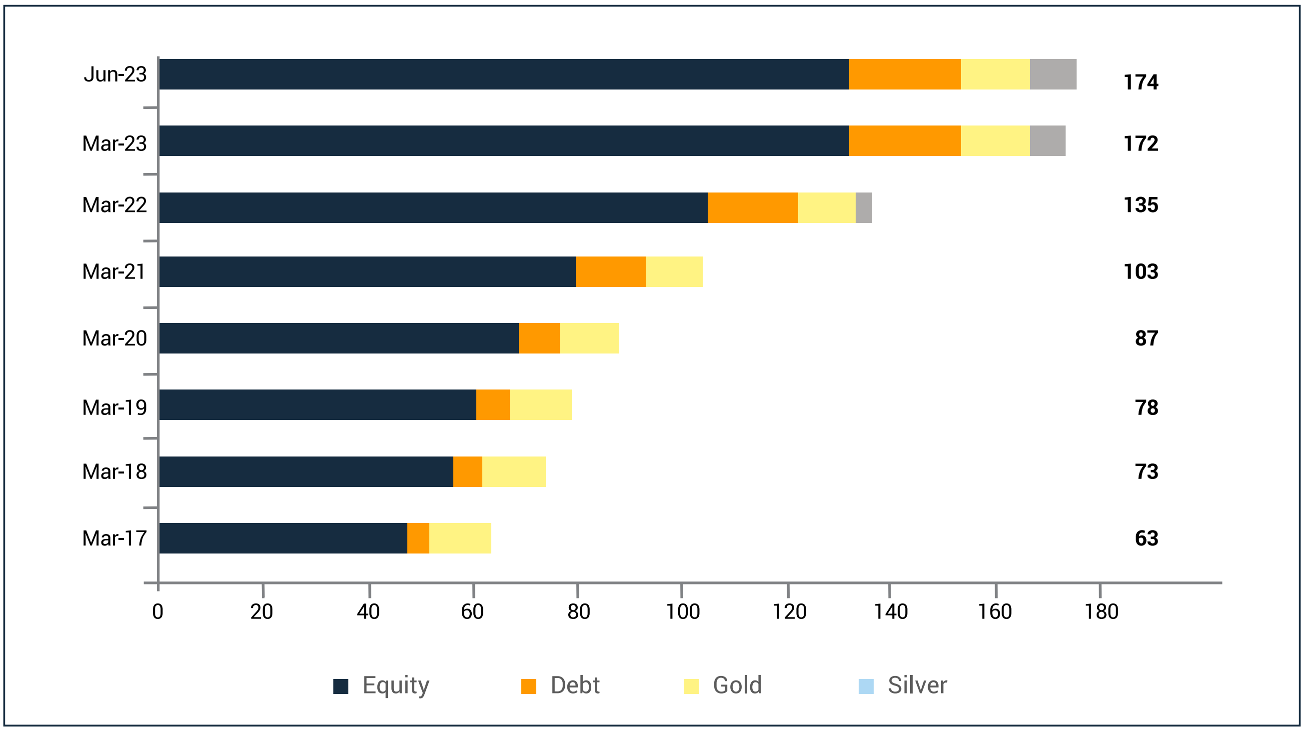
Single & two-factor strategies in ETFs - momentum, quality, value, growth, alpha, low vol. Silver ETF is also an emerging category. Gold ETF is already another popular category.

## Typically redemptions are 40% of new flows and ETFs and grown consistently




*Source: NSE*

## Number of ETFs grew rapidly during COVID19 period




*Source: NSE*

Over the years, several mutual funds have been launching ETFs. Both the number of indices, as well as ETFs tracking indices have shot up significantly. As of 30 June 2023, there were 174 ETFs altogether. The number was just 63 as of 31 March 2017. Recently, debt ETFs have seen lot of new offerings by mutual funds.

## Investors prefer ETFs through direct route

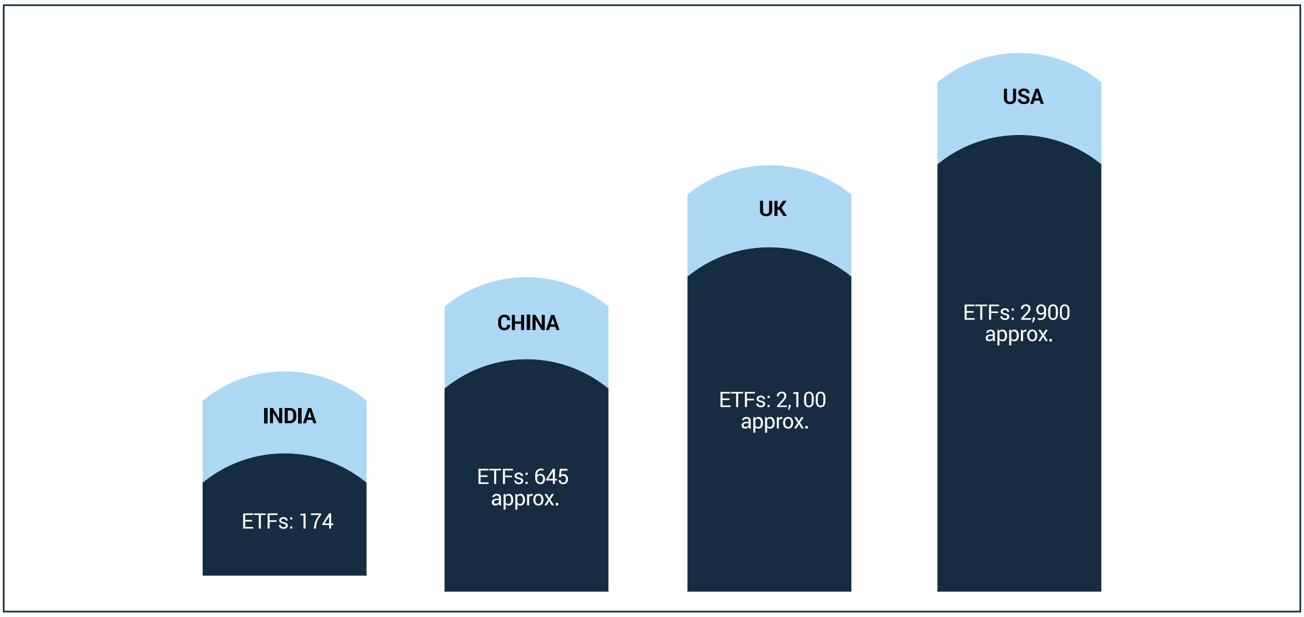
| Period | Trading Volume (Rs. Cr) |
|---|---|
| FY 16-17 | 26,139 |
| FY 17-18 | 33,770 |
| FY 18-19 | 43,519 |
| FY 19-20 | 51,101 |

| Period | Trading Volume (Rs. Cr) |
|---|---|
| FY 20-21 | 65,692 |
| FY 21-22 | 87,188 |
| FY 22-23 | 1,19,682 |

*Source: NSE*

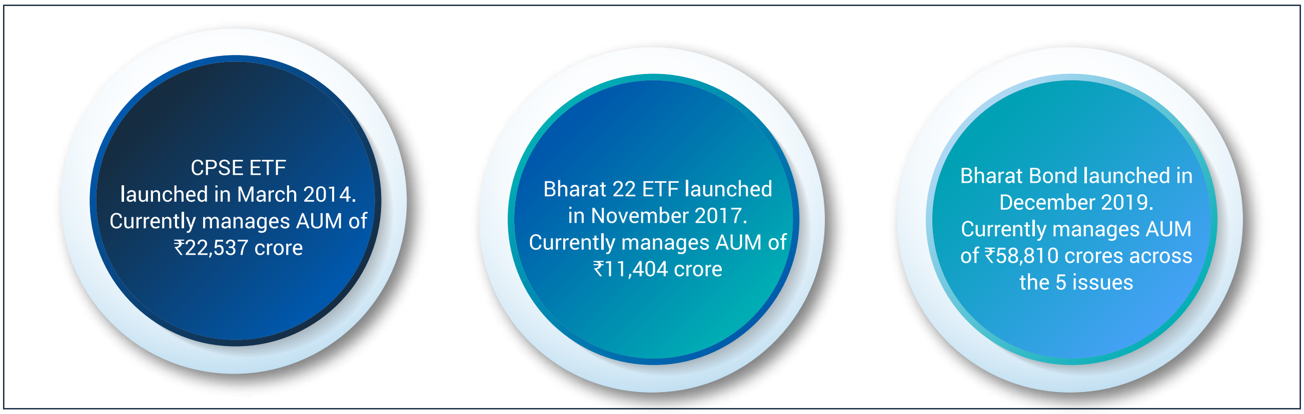
ETF volumes have improved over the years, showing increased investor participation. Higher trading volumes can help with better pricing efficiency.

## ETFs penetration in India lags significantly other countries



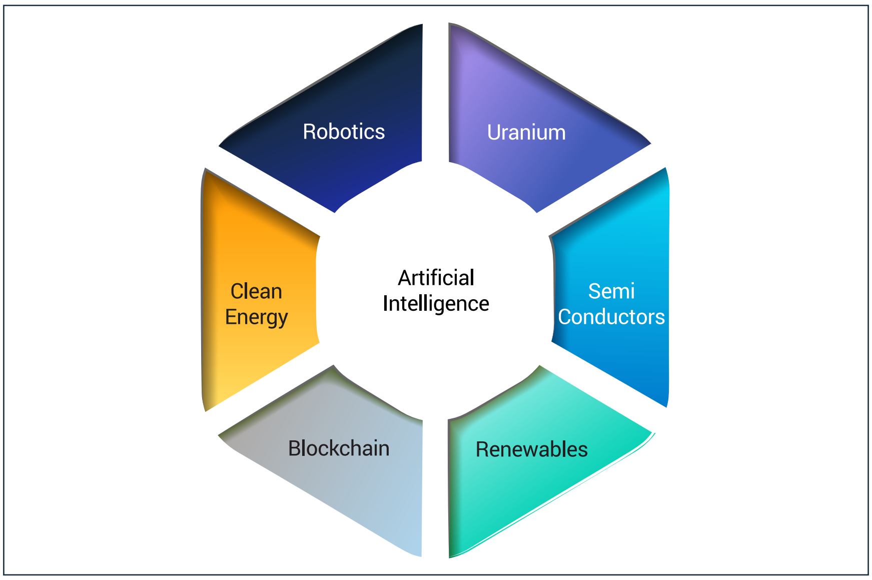

Number of ETFs in India is just a small percentage of what it is in other major markets, showing the huge growth potential.

## In India, government divestment through ETF has attracted many investors




Bharat Bond launched in December 2019. Currently manages AUM of ₹58,810 crores across the 5 issues.

## ETFs listed on global exchanges offer flexible investment themes




## How regulations around ETFs have evolved?

ETFs allow for lot more flexiblity in terms of the investment strategies that can be built in an ETF. In developed markets, a wide variety of investment themes are available for ETF investors. A trend that could play out in emerging markets in future.

Only transactions >Rs. 25 crore can be done directly with AMC.

Transactions <Rs. 25 crore need to be done on exchanges.

Each AMC is required to appoint at least two market makers.

New regulations aimed at improving liquidity on exchanges.

The Securities and Exchange Board of India came with new regulations last year aimed at improving liquidity for ETFs on exchanges. The regulator set a threhold on the value of transactions that can be directly settled with the AMC, so that more transactions are routed through the exchanges to improve overall liquidity. Higher liquidity reduces impact costs.

### ETF units can be bought at a fraction of its underlying

| ETF | Available prices | Price of underlying |
|---|---|---|
| Nifty 50 ETF | ₹214 / unit | Nifty: 19,444 points |
| Bank Nifty ETF | ₹44.88/unit | Bank Nifty: 44,479.05 points |
| Gold ETF | ₹49.78/unit | Gold ETF: ₹4,978/gram |
| Nifty Next 50 ETF | ₹465.57/ unit | Nifty Next 50: 44,346 points |
| Nifty IT ETF | ₹32.48/unit | Nifty IT: 30,924 points |

### Survey of Indian Investors on ETF as an investment category

We surveyed 100 Indian retail investors to understand their views about ETF investing. The survey results suggest that a majority of respondents have invested in ETFs because of their lower cost structure, and most believe that investors can achieve better returns in the long-term through ETF investing compared to active funds. Additionally, a significant percentage of respondents have allocated some portion of their portfolio to ETFs, and the investment horizon for ETFs varies among respondents, with a majority having a long-term perspective (over 5 years).

### ETF Investment Trend:


95% of investors agreed that the trend of investing through ETFs is increasing

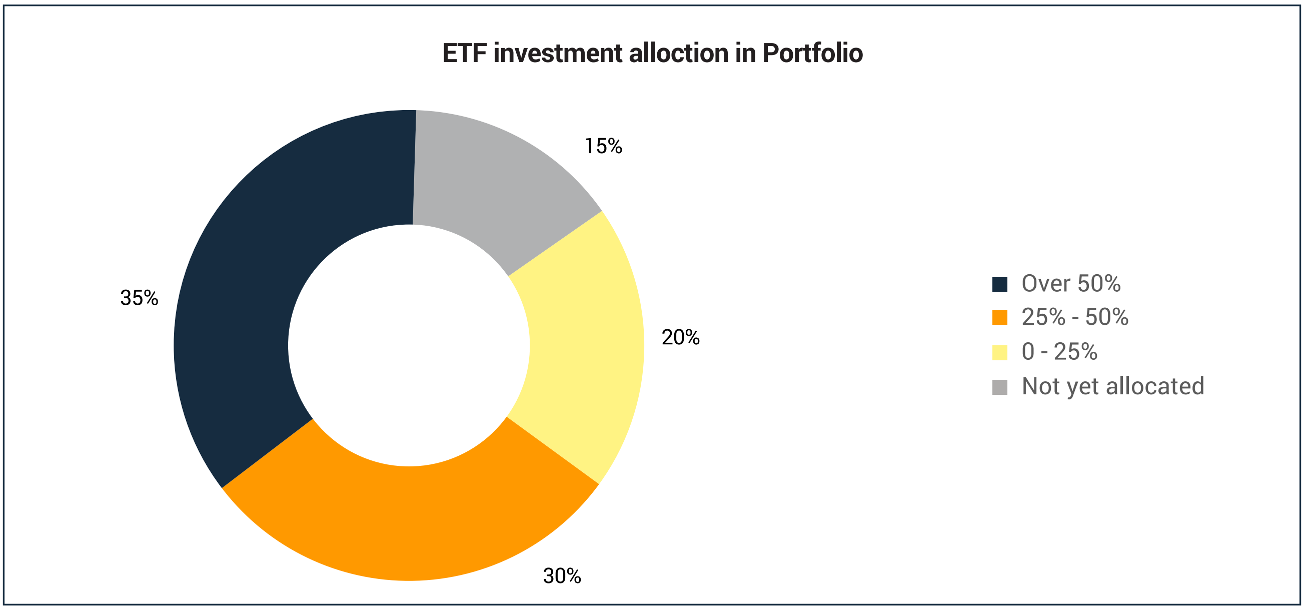
### Reasons for investing in ETFs

The primary reason for investing in ETFs, as reported by 70% of respondents, is the lower cost structure they offer. A smaller percentage, 25%, mentioned better returns as a reason, and only 5% indicated they invested based on a distributor's advice. The survey results suggest that cost efficiency is a significant factor driving ETF investments, with most respondents favouring ETFs for their long-term investment goals and a strong belief in their potential for better returns compared to active funds.

### Portfolio Allocation:

Among respondents, 15% have allocated over 50% of their portfolio to ETFs, 20% have allocated between 25% and 50%, 30% have allocated between 0% and 15%, and 35% have not allocated any portion of their portfolio to ETFs yet.

### 15% ETF investors have more than 50% allocation to ETFs



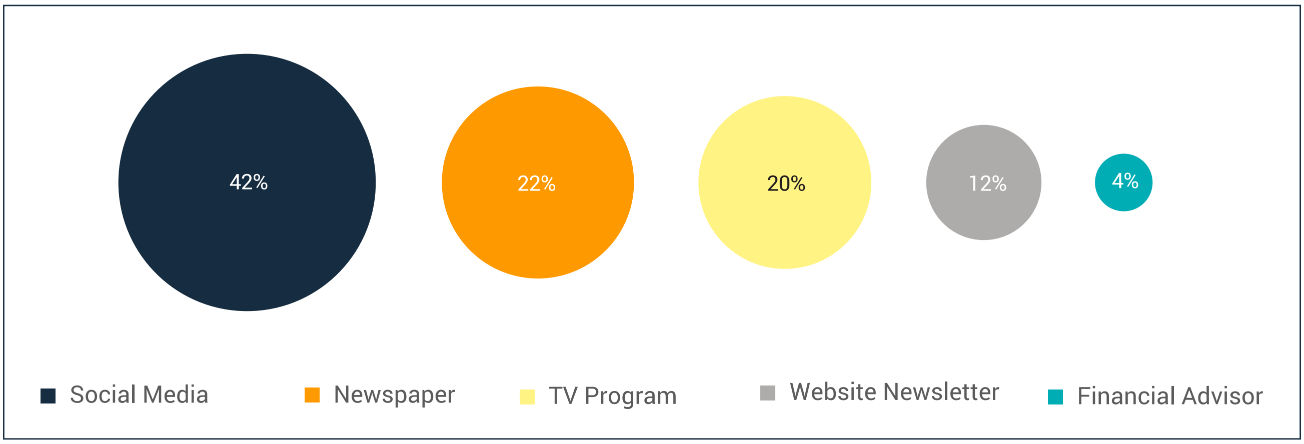

### Duration of ETF Investment:

Respondents' investment duration in ETFs varies, with 10% invested for over 3 years, 42% invested for 1-3 years, and 25% invested for less than 12 months.

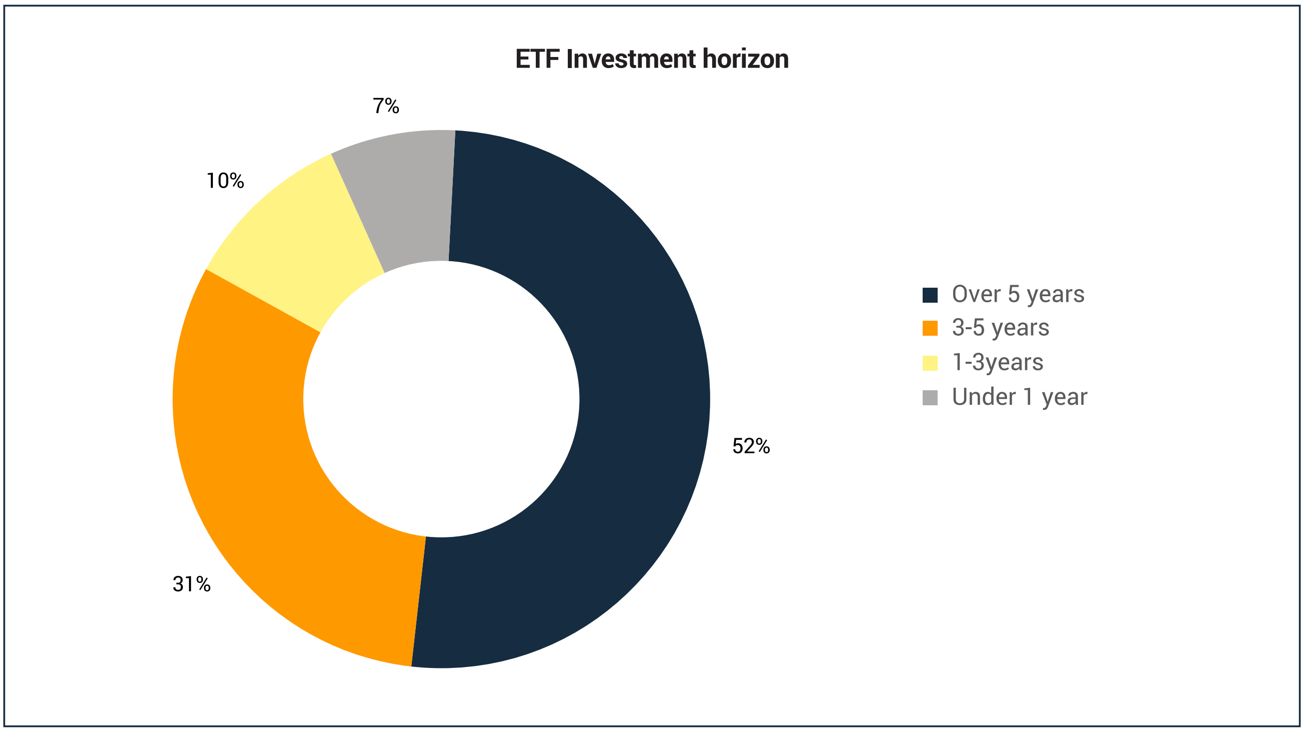
### Source of Information:

The most common sources of information about ETFs for respondents are social media (42%), followed by newspapers (22%), TV programs (20%), company websites and newsletters (12%), and financial advisors (4%).

### Social media is most popular source of information about ETF



## ETF investors have longer term Investment horizon of 5 years

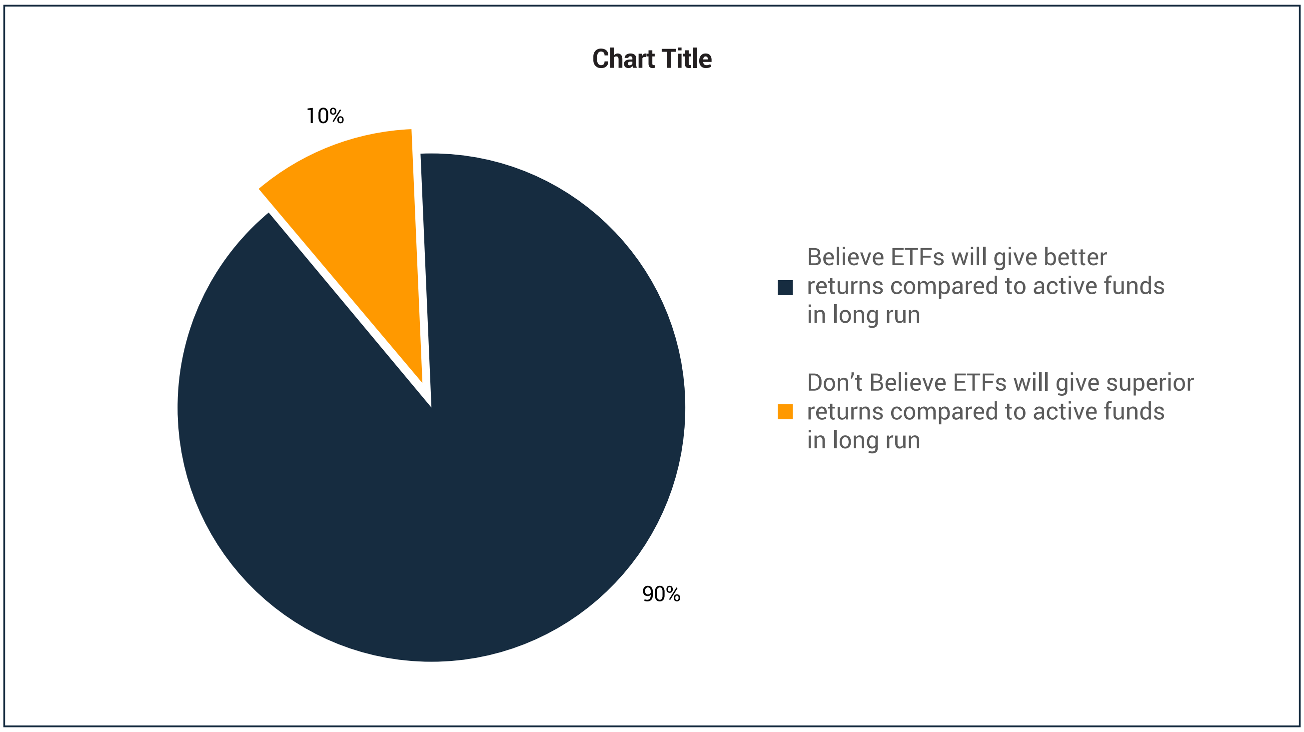



Most respondents (52%) have a long-term investment horizon of over 5 years for their ETF investments. Others have shorter horizons, with 31% looking at 3-5 years, 10% considering 1-3 years, and 7% having a horizon of less than 1 year.

### ETF vs. Active Funds:

A significant majority (90%) of respondents believe that investors will achieve better returns in the long-term through ETF investing compared to active funds, with only 10% holding the opposite view.

## 90% of ETF investors expect better returns than active funds



**Conclusion:**

The ETF industry in India is growing at a rapid pace and is likely to remain a long-term trend. Investors are choosing ETFs as a preferred investment option due to lower cost structure, increased awareness and ease of investing. Government's adoption of ETF as an instrument to divest stake in public sector companies has increase legitimacy of the instrument among retail investors. Most retail investors are taking a long-term investment approach and believe it will offer better returns than active funds in their categories in the long-run.

**Annexure:**

Objective of this survey

The survey was conducted with the purpose of discovering

1) investors' awareness about ETFs

2) the reason for increasing investment in ETFs

3) what are the reasons driving the ETF phenomena

**Approaches to the survey**

The survey was conducted through online and telephonic conversation in Mumbai between August 2023 and October 2023. We collected 100 responses from investors in different income groups and age groups. Over 60% of the respondents were between 20 – 40 age bracket, 35% were in the 40-60 age bracket, while 5% were above 60 years old. 50% of the respondents had annual income above Rs 20 lacs, 35% above Rs 10 lacs, while 15% had less than Rs 10 lac annual income. The survey was conducted with investors who are aware of mutual funds and equities investing and therefore only reflect opinions of an active investor community rather than common public. Even today only 5% Indians invest in mutual funds, hence the survey has to be considered from that perspective.