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ETF market in India: The need of the hour

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Abstract
Exchange Traded Funds are like Index Funds but like shares they are listed and traded on stock-exchange. ETFs combine the features of both mutual funds and shares. Like Mutual funds it provides the benefit of diversification and like shares, buying and selling happens in ETF at a price which is determined real time. Despite having such features ETF market is unexplored in India. The paper seeks to study the Concept, History of Evolution and Current Status of ETF market segment in India. The paper also seeks to recognize the challenges faced by ETF industry and the future prospects.

Keywords: ETF market

1. Introduction
Exchange Traded Fund is a tradable open-ended fund that follows the trend of an index like Index fund, a commodity or a sector similar to Sectoral Index or Commodity Index but is dealt like a share on an stock exchange. ETF issues the proportion of holdings in the form of units to holders/owners.
ETFs combines the features of both the shares and mutual funds in the sense that:
- ETFs incorporate the feature of diversification similar to the mutual funds
- And real time buying and selling like shares.

Objectives
The study is carried out:
i. To understand the concept of ETFs in the light of Mutual Funds, Shares and Index Funds;
ii. To know the history of ETFs worldwide and in India;
iii. To comprehend the current status of ETF sector in India;
iv. To study the structure and Types of ETFs in India;
v. To recognize the advantages, challenges faced and future prospects of ETF segment in India.

Difference between ETFs, Shares and Mutual Funds
For better understanding, comparison between ETFs, Shares and Mutual funds on various attributes is given in the table below:

Table 1: Comparison of ETFs, Shares and Mutual Funds on Various Attributes.

Particulars	ETFs	Shares	Mutual funds
Real time buying and selling and price determination throughout market hours on exchange	Yes	Yes	No
Requirement of Demateralisation account	Yes	Yes	No
Diversification possible with single unit	Yes	No	Yes
Exit load	No	No	Yes
SIP(systematic Investment Plan) facility	No	No	Yes
Brokerage	Yes	Yes	No
Return at par with index	Yes	No	No
Selling price	Very close to actual NAV of the scheme	Market determined price	NAV available on closing

History of ETFs

Canada Launched the first ever ETF in 1989 named as the Toronto Index Participation Fund (TIP 35), followed in 1993, United States launched its first ETF named as the Standard & Poor's 500 Depository Receipts (SPDRs). In 1999 another first ETF was launched in Asia, the Hong Kong Tracker Fund. Finally Europe in 2001 launched its own ETF Euro STOXX 50.

On 8 Jan 2002, Benchmark Asset Management Company Pvt Ltd launched India's first Equity ETF-Nifty BeES (now Goldman Sachs Nifty Exchange Traded Scheme or GS Nifty BeES). Further, in 2003 the Benchmark Mutual Fund launched a money market ETF in India which is incidentally the only money market ETF in the world. It is known as the Liquid BeES (Liquid Benchmark Exchange Traded Scheme). Over the last few years, few more Equity ETFs have been introduced, they are:

Bank BeES-Tracks CNX Bank Index; Junior Nifty BeES-Tracks Nifty Junior Index; ICICI SENSEX Prudential Exchange Traded Fund-Tracks Sensex

Benchmark again pioneered in the launching of first gold ETF in India in 2007 known as Gold BeES. Since then ETFs has come a long way. Presently, there are 42 ETFs of which 12 are in Gold segment and only 21 in other segment. Goldman Sachs Asset Management Co. (Took over Benchmark AMC in July 2011) is the leading player in the Indian ETF segment with as many as industry 9 schemes.

Structure and Categories of ETFs in India

Structure of ETFs in India

In Mutual fund small number of large investors buy units of funds. The corpus so formed is used by the Fund Manager appointed by Asset Management Company to create a portfolio as per scheme. On redemption request Fund Manager sells a part of portfolio to pay cash and on purchase further securities are purchased by the manager. Thus the units in Mutual Funds are called "in-cash" units.

On the other hand in Exchange Traded funds there are" Authorized Participants, selected by the Asset Management Company. They will create the portfolio with the shares comprising the index or in case of Gold ETF buy the actual gold and then deposit it with custodian who will then issue creation units which are further spilt into small units and issued to the investors. Since these units area created by depositing real gold/shares, the units are called "in-Kind" units. In case of gold ETFS in case of redemption the actual gold is sold and in case of purchase more of gold is purchased to create more units.

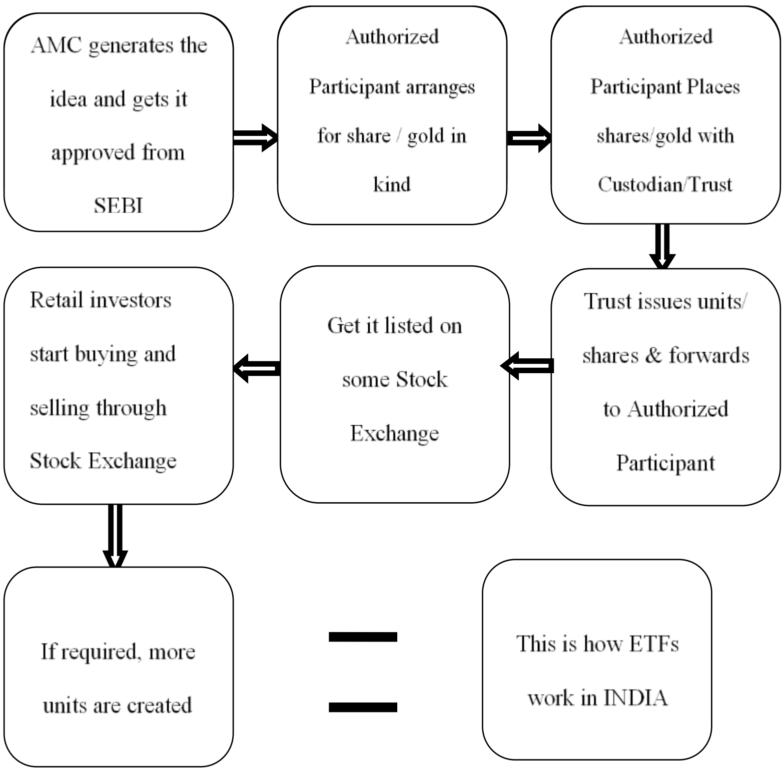


Chart 1: Structure of Gold ETF

Categories of ETF's in India
Presently there are three categories of Exchange Traded Funds which can be traded in India. These are:

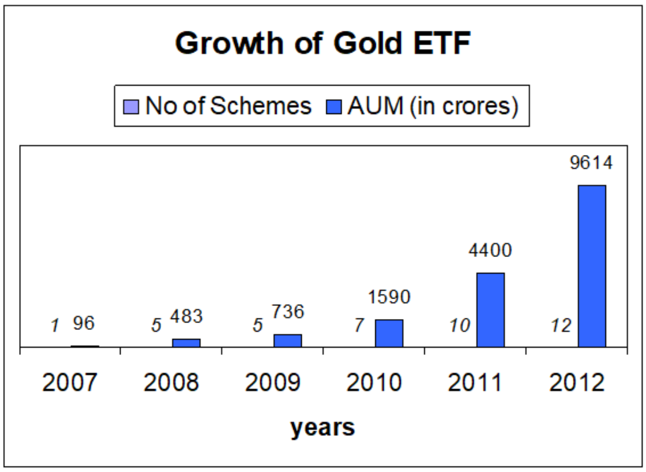
- Equity Exchange Traded Funds
- Liquid Exchange Traded Funds
- Gold Exchange Traded Funds

Equity ETF's: Equity index ETFs are funds whose unit price is derived from basket of capital market securities. These basket of securities differ depending upon the nature of ETF for example value of NIFTY BeES or UTI SUNDER is derived from securities that comprises NIFTY index.

Liquid ETF's: Liquid ETF's are the money market ETF's, the investment objective of which is to provide money market returns. Liquid BeES tracks CRISIL Liquid Fund Index. Liquid BeES invests in a basket of call money, short-term government securities and money market instruments of short and medium maturities.

Gold ETF's: Gold ETF is a special type of Exchange traded fund that tracks the spot price of gold. A gold ETF unit usually represents either 1 gram of gold or half gram of gold so that small investors can buy.

Current Status of ETFs in India
Though the industry has grown exponentially in the last 10 years, it is still at a nascent stage with ETFs largely catering to two asset classes, viz., equity and gold. The only fixed income ETF is the Goldman Sachs Liquid Exchange Traded Scheme (GS Liquid BeES), which invests in call money and other money market instruments. Equity ETFs include broad market index ETFs, sectoral index ETFs and international equity index ETFs. Gold ETFs (launched in 2007) have been the primary driver for funds in this category; compared to other ETFs, gold ETFs have seen an upward trend in the past few years.
"India has twelve gold ETFs currently listed with a total collection of more than 15 tonnes, up 57 percent on a year ago. India's gold ETF collection is small compared to its approximately 700 tonnes of annual gold consumption. But industry players suggest it could rise by at least 50 percent year-on-year. Mumbai-based Benchmark Mutual Fund, owned by Goldman Sachs Asset Management has the largest collection of more than eight tons. The gold ETFs are listed on India's National Stock Exchange and most of them have a minimum individual share size of one gram" [1]. As on Sept 2010, there were 10 only companies which were offering ETF products. Total Asset under Management for these companies accounted for ₹ 304133 crores. Benchmark Asset Management Co Ltd (now Goldman Sach) alone accounted for ₹122906 crores of AUM [2] under AUM, i.e. nearly 40%.



Graph 1: Growth of ETFs since 2007 to 2012

Note: for all the years figures are on 31 March except for 2012 which is as on 31st Jan
On 31st Jan 2012 total AUM were ₹659153 crore out of which only ₹11259 crores were in ETFs i.e. ETFs comprised only 1.7% of the total AUM. Further in ETFs it were the gold ETFs which accounted for nearly 85% of ETFs AUM. As on 31st Jan 2012, AUM of gold ETFs increased significantly to ₹9614 crores from ₹1008 crores in Sept 2009 i.e around 850%.
Market uncertainty, Indians love for gold, ever increasing price of gold, high returns and the increasing importance of gold as an asset class have led to Gold ETFs to be most popular and in demand asset class among ETFs.

Advantages of Holding Units in ETFs

i) **Diversification:** Diversification means taking advantage of holding units or shares across different asset class. Diversification is also known as not putting all eggs in one basket. By holding shares/units across asset class, the holder is able to minimize the risk as compared to holding entire investment in just one class of shares. Achieving such diversification is not possible for a single investor with small resources. However, ETFs just like Mutual Funds offer the advantage of diversification through a single investment to the investors. Eg: ETF like NIFTY BeES provides the most affordable (unleveraged) way of 'buying Nifty'.
ii) **Global Exposure:** Only few ETFs offer the global exposure to the investors by investing in securities overseas. For example:-GS Hangseng BeES tracks Hong kong stock exchange
iii) **Lower Tracking Error:** ETFs have lower tracking error due to in-kind creation and redemption.
iv) **Trades like a Share:** ETF units are bought and sold real time like shares during market hours.
v) **No Minimum investment limit:** Minimum investment is one unit.
vi) **Low Asset Management Cost:** As ETFs try to reproduce the trend of underlying Index or sectoral index, they are passively managed. ETFs do not require constant monitoring like mutual funds. They hold the portfolio as the representative sample of securities in the underlying Index. As ETF are passively managed they have less operating costs. Also they don't exit and entry loads like Mutual Funds. The overall operating costs and expense ratio is low and the benefits of low cost is

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1 http://archive.indianexpress.com/news/gold-exchangetraded-funds-(etfs)-mushroom-in-india/833784/0
2 AUM-Asset Under Management

ultimately passed on to the investors.

vii) **Information Dissemination:** Like all other stock exchange listed securities ETFs also has to fulfill disclosure necessities of the related exchange. The level at which underlying benchmark Index is trading is publicly available, so is the list of securities constituting the index. ETFS are a reflection of underlying Index and in its portfolio holds the same securities as in Index. Not only are this information, price quotations for trading in ETFs available real time during market hours.

viii) **Real time NAV calculation:** The prices of ETFs is reflected in the form of NAV and its available real time which makes it easier for the investors to assess the performance of ETFs.

Challenges Faced by ETF industry

The ETF market segment is still not that lucrative to the investors, this can be attributed to a following limitations.

i) **Indices Outperformed:** Unlike developed markets such as the US where fund managers find it hard to outdo benchmark indices, in India Mutual funds which are actively managed have outperformed ETFs on many platforms. Investors obviously wants a higher return therefore they have more inclination towards mutual funds.

ii) **Index Vs Diversified Funds:** Diversified Equity Mutual funds have consistently outperformed Equity ETFs. ETFs looks in their nascent stage.

iii) **Liquidity:** Liquidity is again another issue which makes ETFs less attractive to investors. Generally, ETFs are not easily convertible to cash as Mutual Funds.

iv) **Brokers Lack Incentive to Sell:** ETF units are purchased through stockbrokers, unlike Mutual Funds, which follow the distribution model. Brokers have no special incentive to sell ETFs and in fact, find it more profitable to promote individual stock investments. Fund houses have to educate brokers on ETF benefits.

v) **Changes in Index Components:** The composition of ETFs mirrors that of the underlying indices. Frequent changes in index components requires changes in portfolio of ETFs also. The fund manager has to remove /sell the security that goes out of index and include the security that enters the index in its portfolio. All this involves cost which has to be borne by the investor.

vi) **Expense Ratio:** The operating and other expenses incurred on the scheme affect the returns. Lower the expense ratio, higher will be the returns. Since the Exchange traded Funds are passively managed the charges are bound to be low. But this has not happened in India. Internationally ETFs average charges are close to .53% but in India most of the equity related ETFs are charging more that this-some even charging 1.3%. The reason may be lack of penetration of ETFs but still the higher charges are negatively impacting the investor's attitude towards ETF segment.

Future Prospects

ETFs segment in India has huge growth prospects in the future due to extensive value benefits offered by it in relation to both shares and mutual benefits. It caters to both risk averse and risk takers investors. However, current status of ETF industry in India does not depict that rosy picture. ETF market in India is still unexplored, it is highly unpenetrated. The reason of that may be ETFs offering lack width and depth and on the top of it liquidity. Benchmark is the Asset Management Company that have tried to explore the segment. The segment offers a huge opportunities for other players to enter and make their mark.

Another thing that is lacking is the depth in the segment. Depth means having larger number of ETFs schemes with varying features. Right now in India largely only two types ETFs are there: Large cap equity funds and Gold ETFS. There is dearth of ETFS providing global exposure to the investors. On commodity side also only gold ETF is there. Indians have preference for gold and silver, so silver ETFs can be introduced. Besides silver, ETFs in other commodities like oil, energy can be introduced.

Another issue of liquidity must also be tackled to build investors' confidence. Entry of new players will increase the depth, width and liquidity in ETF market. ETFs that track other asset classes like real-estate, precious metals and currencies, commodities like oil, provide opportunities to further distribute risk. This, coupled with the inherent advantages of ETFs will surely lead to higher investments in the future. However, there's a long way to go before these funds become the first choice of investors.

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