S&P Dow Jones Indices

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RIA Talks India

A Practical Look at Passive Investing

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RIA Talks India is an interview series where industry thinkers share their thoughts and perspectives on a variety of market trends and themes impacting indexing and passive investing in India.

Koel Ghosh, Head of South Asia at S&P Dow Jones Indices (S&P DJI), chatted with Ladder7 Financial Advisories' Suresh Sadagopan to get his take on using passive investing as a tool for risk management.

Koel: As an index provider, S&P Dow Jones Indices would like to better understand how financial advisors use products based on indices. Please tell us about passive products like ETFs and index funds that can be used in an advisor toolkit in India.

Suresh: As a financial advisor, the choice to include various products in a portfolio is dependent upon the investor's risk appetite, reward expectation, liquidity and tenure needs, taxation, etc. While choosing products, advisors will also have to contend with managed products and passive ones. There are merits on both sides, in some subcategories at least.

In the large-cap space, most funds are not able to beat index returns, after adjusting for fees. In mid- and small-cap spaces, active funds seem to be able to beat passive funds more frequently. Hence, having some ETFs or passive funds may be helpful in the large-cap category. Also, in the smart beta (or factor) investing space, many ETFs (and passive funds) have started sprouting up, and they could be good candidates to consider in certain portfolios.

Koel: What are some of the strategies you use, and what are the potential benefits of including passive products in a portfolio?

Suresh: It is our belief that capturing the wisdom of the markets will eventually shine over stock-picking skills. However, it may take some time to mature in India before we get to a stage similar to what the U.S. is experiencing now.

We use ETFs and passive funds that track broad indices. We also use smart beta funds as a satellite strategy in our overall passive investing strategy. However, what we do differs from client to client.

The benefits of passive investing can be manifold. Fund manager risk is mitigated, and typically lower-cost investing is facilitated. Passive vehicles may also have advantages for long-term investment in that the underlying index reconstitution infuses dynamism for a portfolio of stocks. It can help to create a manageable portfolio that encompasses nearly the entire market.

Koel: How do you position your ETF use to clients?

Suresh: We prefer index funds for their liquidity, ease of trade, lack of impact costs, and buyback. We educate our clients about why passive investing may be a good strategy and why we are choosing that for them. We also explain all the typical benefits of the passive products, including potentially the lower cost, mitigation of fund manager risk, automatic alignment periodically to a well-constructed index, etc.

We have tried using ETFs in the past. However, there are some issues that we are currently facing with regard to ETFs in India. Liquidity can be a problem in ETFs when looking at higher volumes. Impact cost is high in a lot of cases, which negates any lower total expense ratio of ETFs. Unlike passive funds where the asset manager is the counterparty, for ETFs, another person who wants to buy is the counterparty when one wants to sell. So there is no assurance that one will be able to sell off ETFs when one wants at near-market prices. Additionally for ETFs, clients require a dematerialization and trading account, which in some cases, they may not have. Reporting can be a problem, as ETFs in dematerialization accounts and those as mutual fund holdings may be reported separately.

Koel: Have indexing and ETF use changed your investing behavior or your clients' behavior?

Suresh: We are advisors looking forward to using new tools and strategies that are good fits for our clients. Index products are one such tool. Hence, we may look to use them more and more as we get to see more products in this space and as passive investing itself evolves.

Koel: As an active manager who is using passive tools, how do you describe this blend of capabilities, and what is the mix of active and passive you favor?

Suresh: We see our role as financial architects who are using available products to build a financial edifice for our clients. Hence, we are product- and strategy-agnostic to a great extent. We choose products that are suited to our clients and help in achieving their goals and funding their expenses.

At every point, we evaluate what makes sense for our client set and suggest that mix for the client. Currently, we find that we use 10-25% passive investment-oriented products. However, it is an evolving situation and it could be a higher number in the future.

Koel: Finally, do you see more RIAs in India adopting this approach?

Suresh: RIAs are using passive strategies today, and they are the ones who will promote passive products if they mesh well with their advisory approach. The use of passive vehicles may likely increase in the years to come as the choice expands, the offerings mature, if costs go down, and a good track record gets built for passive tools vis a vis their active counterparts.