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TalkingPoints

How Diversification and Index Innovation Are Powering Passive in India

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Passive investing continues to grow in India, with a CAGR of 49% over the last decade. As regulations and markets continue to evolve, how large is the potential of passive in India and what strategies are in the mix that could fuel this upward trajectory?

Koel Ghosh, S&P DJI's Regional Head of South Asia sat down with Motilal Oswal Asset Management Company's Head of Passive Funds, Pratik Oswal to take a closer look at passive trends in India.

1. What are the main drivers of passive investing in India?

Koel: The passive investment space is in its nascent stage in India, though it is growing steadily. At over USD 25 billion assets under management and nearly 86 products, this space accounts for a small percentage of the USD 6 trillion global passive market. The potential of passive is slowly being unleashed through education and awareness, along with government support. The Employee Provident Fund's allocation to ETFs and the disinvestment program routed through the same passive option has created the opportunity for more visibility and understanding for investors. Further, the underperformance of active funds in particular categories reflected in our bi-annual S&P Indices vs. Active (SPIVA®) research, continues to fuel interest in passive strategies in the region.

2. What kinds of passive strategies are Institutional Investors using in India and where do you see potential for future innovation?

Pratik: Asset managers in India have embraced passive innovations, using strategies designed to access sectors and industries like banking, and themes including Environmental, Social, and Governance (ESG) and consumption are gaining traction. Smart beta (or factor-based investing) as a category has also seen continued innovation, both in single- and multi-factor strategies. In our opinion, the biggest impediment for the success of passive funds has been education and awareness. With higher awareness, we would expect interest in traditional index-based and smart beta products to increase in the future. Vanilla products may have a larger role to play in building the marketplace before more innovative products take off. Due to regulations and liquidity factors, large-cap ETFs are currently the preferred passive instruments for institutional investors.

3. Can you discuss the importance of diversification and how indices can be tools for asset allocation decisions?

Koel: Diversification is a well-established investment approach for minimizing risk. Indices provide a tool for assessing the performance of a market segment and, when underlying an index-based product, for accessing a basket of securities that is aligned with an investment objective. Indices cover a wide range of market segments and strategies that vary from regional equity benchmarks like the S&P 500® for the U.S. and the S&P BSE SENSEX for India, sectors like Healthcare and Information Technology, factors like low volatility and quality, different asset classes, or strategies combining factors, or those tracking themes such as dividends.

4. What kind of access does a local investor have to international diversification?

Pratik: Home bias has been a prominent theme in India. However, a bigger reason why Indian investors do not tend to invest internationally may be again due to lack of awareness. Until recently, most investors did not know they could invest internationally via mutual funds. I believe there are many options for Indian investors looking at international diversification opportunities. Despite there being 30+ mutual fund houses, a lot of Indian mutual funds have historically not focused on international opportunities. Due to regulatory reasons, providing low-cost feeder funds is not feasible for asset managers in India.

5. Why have you focused on index funds versus ETFs for international exposure?

Pratik: We focus on index funds for both domestic and international exposure and we believe that international diversification is something all portfolios should have. Index funds and ETFs are simple, transparent, low cost instruments that we are more comfortable holding, and we have found them to be more effective in terms of risk-adjusted returns over long-term periods. International exposure can offer allocation to an asset class that is often uncorrelated to domestic equities, without necessarily giving up on returns, which we've found advantageous historically. Being 100% in U.S. dollar terms, it can provide investors with exposure to two asset classes—U.S. equities and U.S. dollars.

6. When you evaluate passive strategies, how important is the underlying index?

Pratik: The underlying index is fundamental since most passive strategies are designed to replicate the underlying index. We analyze brand recall of the index provider, liquidity, transparency, scalability, and the specific risk-adjusted return profile of the underlying index. We typically position all of our products as the building blocks for asset allocation. If a product suits a need at the asset allocation level, we consider it. The entry barrier, however, is simplicity. With thousands of mutual funds and thousands of other investment vehicles currently present in India, we hope to simplify the number of options available via passive funds. If we believe a specific index will help simplify the investment process and make it easier and stress free, we'll strongly consider it.

7. What do you think needs to happen in India in order to advance the passive investing curve?

Koel: As we have discussed, we definitely need to continue providing more education and awareness for investors and product providers. The Indian market is waking up to the potential advantages of indexed solutions and market beta. Index products in India have progressed from plain vanilla asset classes, geographies, segments, and market benchmarks to more advanced concepts and that's expanding the potential role of passive investment products in India. These new innovative indices are breaking ground on investment themes and passive products linked to them may offer investors increased variety when building portfolios. As a result, we think the market needs to explore the growing range of indices, and product providers should consider building out a suite of offerings for investors to choose from, which will help the market grow and mature, and allow investors to work toward achieving a broader range of objectives.