IJMRRS

International Journal for Multidisciplinary Research, Review and Studies

ISSN: 3049-124X (Online)

Volume 1 - Issue 3

2024

Title – "Passive Investments: Trends, Challenges, and the Road Ahead in India and Global Markets"

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Abstract:

Purpose – The evolution of Indian stock market has been beneficial in various sectors, one of those sectors is Passive Investing. Passive Investing specifically involves, investing in the stock market index, passive investors believe that the maximum profit is equal to the return from the stock market index. This article is a comprehensive study of the Indian and Global market exploring Passive Investing, the benefits and drawbacks of the same.

Objective – The objective of this article is, to explore the field of Passive Investing that covers, data on AUM (Assets Under Management) of ETFs (Exchange Traded Funds) held by the top 10 AMCs and a comparison with the global market (U.S. and China). Further, analyzing the costs involved (Total Expense Ratio) versus cost of active funds. According to SPIVA India Scorecard, nearly 52% Indian Equity Large Cap funds, actively managed in S&P BSE 100 underperformed their benchmark. The study addresses liquidity and volatility issues faced while including beyond top 250 passive stocks, as Small Cap stocks are sensitive to market events and experience significant price fluctuations.

Findings – The research reveals important findings on the vast market of ETFs and Index Funds, highlighting their growing popularity in the Indian market, while addressing the risk-profile of index funds through potential SEBI solutions.

Recommendation – The suggested recommendations to include beyond top 250 stocks in India is, to improve their asset management system to ensure complete disclosure of information and segregating small cap stocks to monitor and control market volatility.

Keywords – Passive Investing, ETFs, market volatility, AMCs

Introduction

As of November 2024, 80% of Indian investors have increased their allocation towards index funds and ETFs (Exchange Traded Funds) in the past year. Passive Investment means buying and holding the investment for a long period of time. The investors who believe in Passive Investing, invest in stock market index and according to them, the maximum possible return that can be made in stock market is the return from the stock index. This approach during investment involves identifying the patter of stock index and replicating it. It is different from Active Investment in many ways, profits made, risk involved, methodology, ideas, etc. The Passive Investment approach believes that individuals investing in stock index are rational and make the right decision by investing in the stock market index.

ETFs (Exchange Traded Funds) are the funds that can be purchased through exchange such as BSE (Bombay Stock Exchange), NSE (National Stock Exchange) only, they cannot be bought from individual companies. Index Funds are also a form of Passive Investing, they are investment funds that follow a benchmark index, such as S&P 500 or the Nasdaq 100. The purpose of this research article is to, dive deep into the world of Passive Investing, analyzing the trends in Indian markets and its comparison with the global markets and its future prospects. The article will be following a structure, that would include the analysis on AUM (Asset Under Management), expense ratio, fund performance, tracking error and the need for passive investments.

Literature Review

To understand Passive Investments and its trend, we need to analyze and understand how it began and came into existence. In 1602, 1st stock market was born in Amsterdam, the Dow Jones index was created in 1896 and the S&P 500 in 1957. Before these dates it was practically impossible to bet on “the market” as a whole. This was then followed by the introduction of the 1st index funds signed by Wells Fargo investment advisors for Samsonite’s pensions fund. The ETF market was strengthened by the launch of Morgan Stanley’s WEBS (World Equity Benchmark Shares) managed by Barclays Global Investors (BGI). This shift in the stock market from Active Funds to Passive Funds coincided with the industry adoption of new information technologies that enabled rapid transmission of data at low costs. A study conducted by Nataliya Nedzhetskaya (University of California) reveals a relationship between shifts in firm-level practices and the launch of index funds. Greater adoption of information technology led active mutual funds to increasingly resemble passive index funds in both properties and price point, allowing firms to gradually attain the necessary technical competencies and lowering the" cost" of transitioning from high-profit active funds to low-profit index funds.

Thus, passively managed funds played a key role in the market, providing a wider concept that was not limited to a few companies but provided exposure to a completely new concept in the field of stocks and investing.

Methodology

In this research article, the key matrices that have been analyzed are AUM (Asset Under Management) growth rates, Expense Ratios of actively and passively managed funds, Tracking the errors in passive management and liquidity measures. All the data has been gathered from SPIVA Reports, SEBI Data, Market indices of the past five years (2019 – 2024).

The top 10 AMCs in the world are:

Black Rock (US)	10,473
Vanguard Group (US)	9,300
Fidelity Investments (US)	5,303
State Street Global Advisors (US)	4,340
Morgan Stanley (US)	3,639
JPMorgan Chase (US)	3,564
Credit Agricole (France)	2,858
Goldman Sachs (US)	2,848
USB Group (Switzerland)	2,620
Capital Group (US)	2,600

On the left side of the table, we have the top 10 AMCs in the world and on the right side of the table, we have the balance sheet of total AUM (in US$b) as on 31st March, 2024.

Source- www.advratings.com

The total AUM of India is rupees 69,32,959 crore (source – www.amfiindia.com)

The total AUM of the world is 47535 US $b

Representing this as a percentage of total AUM of India would give a very small fraction of a percentage that is 0.00006856%

Expense Ratio, the cost of owning a mutual fund or ETF, specifically the management fee paid to the fund company for the benefit of owning the fund is called an expense ratio.

In India, expense ratio of active funds is more than the expense ratio of passively managed funds. To understand this concept in the context of Passively managed funds, we have the following passive funds and their corresponding expense ratios as of November, 2024:

Union Mutual Fund	0.88%
Nifty Mutual Fund	0.20%
NSE Gold	0.65%
SBI BSE	NIL
SBI Nifty 50	NIL
SBI Nifty Next 50 Index Fund	0.33%

Source - www.amfiindia.com

Through this report, we can estimate that the average TER (Total Expense Ratio) of passively managed funds ranges from 0.30% to 0.90%

On the other hand, the average Total Expense Ratio (TER) in U.S. is estimated to be 0.36%

Source – www.morningstar.com

In India, the expense ratio or the cost of maintaining an active fund is generally higher than maintaining passive funds. The TER of active funds in India is between 0.5 & 1%.

Fund Performance

In this section of the article, data has been collected on underperformance of active funds in India.

Active funds are the funds that are maintained considering the current, past and future conditions of the stock market. This involves accessing the risks and trying to minimize it through smart fund allocation. Despite this, over **52%** of Indian Equity Large-cap funds failed to outperform the **S&P BSE 100** index in 2023. This data from SPIVA India Scorecard 2023 questions the effectiveness of actively managed funds, since 2023 was a strong year for the Indian stock market. On the other hand, **ELSS** (Equity Linked Savings Scheme) funds were the only category where a majority **(70%) outperformed** their benchmark (**S&P BSE 200**) across all time horizons measured. In mid and small cap market, **74% Indian Equity Mid/Small-Cap** funds underperformed the **S&P BSE 400** MidSmallCap Index in 2023. **58%** of **Indian ELSS** and Indian Equity Mid-/Small-Cap funds underperformed the **S&P India BMI. 75%** of ELSS funds underperformed the **S&P BSE 400** Indian Equity MidSmallCap Index. **81.5%** of **S&P BSE India Government Bond Index** underperformed in 2023.

Challenges faced by Passive fund managers

There is a regulatory requirement that mutual funds must assign a risk profile or rating to their schemes to help investors understand the risk involved in that particular scheme. However, in case of passively managed funds, this ratio is difficult to maintain since index funds track their benchmark index exactly. Thus, the risk level of an index fund changes as the underlying index composition changes. Therefore, it becomes difficult to assign a risk ratio to an index fund.

Challenges beyond the top 250 stocks for diversification in India

The challenges include the difficulty faced while trying to diversify a portfolio by including stocks beyond the top 250 stocks. The challenges faced are specifically liquidity issues, small cap stocks are not traded on a regular basis and this can cause fluctuations in price movements, making it difficult to buy or sell stocks at stable price. Another challenge arises while managing these stocks, as managing them requires more sophisticated strategies and resources. Small companies often provide inconsistent financial reports that makes evaluation of the stocks challenging. To overcome these challenges and to ensure diversification of the portfolio, SEBI (Securities and Exchange Board of India) should assign separate heads to monitor the flow of information from Small Cap companies, rate of volatility. They should also segregate small – cap and large and mid-cap companies to control market volatility.

Need for Passive Investments

For boosting customers' lifetime savings, ETFs and Index Funds are excellent investment methods to adopt. They track an index exactly meaning, the individual investing in a particular passive fund need not study about the shares separately or track their progress, they have to track the principal index. This is a boon for those who want to invest but have minimum knowledge about the stock market or are afraid to invest because of the vast stock market. A study by Patrick J. Cotton (University of New Hampshire, Durham) has revealed the advantages of ETFs and Index Funds.

An analysis by **Morningstar** found that index funds and exchange-traded funds (ETFs) have outperformed actively managed funds over the long term (Morningstar, 2023). This is due to the fact that index funds and ETFs are created to track the performance of a particular market index, making them a more affordable and effective investment choice for novice investors. Actively managed funds, on the other hand, charge higher fees and are run by managers who aim to outperform the market, which can lead to underperformance. Another study by **Vanguard** found that diversification through index funds and ETFs can help reduce portfolio risk and increase returns over the long term (Wallick). This is due to the fact that index funds and ETFs provide exposure to a variety of asset classes, such as equities, fixed income, and commodities. This can assist investors in constructing a diversified portfolio that is suited to their unique investment objectives and risk tolerance. Contrarily, investing in a single stock carries a higher risk and is more volatile, which can lead to sizable losses. Furthermore, according to a **BlackRock** study, index funds and ETFs can provide exposure to a variety of investment strategies, including factor investing and ESG investing (BlackRock Global Business Intelligence, 2023). This can assist investors in achieving their investment objectives while remaining true to their values. Actively managed funds, on the other hand, may not align with an investor's values and may have higher fees, as mentioned before.

Saving Model (https://1drv.ms/x/c/40d23ffe980e1785/EWBvKZmH1edFrSM95bghB0oBQyJxGKrNEm8u4-DvUBGdjA?e=R29mPO)

TRACKING ERRORS

Tracking error of passive funds typically means, analyzing how well a particular fund can mirror the index. It is more about performance of a fund, it is specifically about the variability of the performance, it indicates the consistency of a product’s tracking difference during a time period. It is calculated as the “Annualized Standard Deviation of tracking difference”.

Tracking errors of some Indian passive funds as of 1st Jan, 2025 are analyzed in the table below:

Scheme Name	Benchmark	Tracking Error (%)

Aditya Birla Sun Life Nifty 200 Quality 30 ETF	NIFTY 200 Quality 30 Total Return Index	0.16%
Aditya Birla Sun Life Nifty 50 Equal Weight Index Fund	NIFTY 50 Equal Weight Total Return Index	0.07% (regular)
Aditya Birla Sun Life Nifty 50 ETF	NIFTY 50 Total Return Index	0.04% (regular)
Aditya Birla Sun Life Nifty 50 Index Fund	NIFTY 50 Total Return Index	0.04% (regular)

Source - (www.amfi.com)

By studying this table, it is clear that tracking error (%) is not more than 0.5 % which means that the funds are following the index well.

Here is a table of tracking errors of passive funds in the U.S.

Scheme Name	Tracking error (%) 1 - year	Tracking error (%) 3 - year	Tracking error (%) 5 - year
SPDR S&P 500 ETF Trust (SPY)	24.89	12.48	14.47

Corresponding this fund, here is the table of the index it is following and the tracking error

Scheme Name	Tracking error (%) 1 – year	Tracking error (%) 3 – year	Tracking error (%) 5 – year
SPDR S&P 500 ETF Trust (SPY)	24.6	12.55	14.66

Studying these two tables, shows that the difference in the error terms is minimal, 0.2% (tracking difference) (roughly). Thus, comparing the tracking error of Indian funds with U.S. funds, it is concluded that, U.S. funds track their index better.

There are many reasons that lead to tracking errors, first is mutual fund expenses that includes cost of buying and selling stocks, management expenses, etc. Higher expenses lead to greater tracking error. Another reason is, cash balance in the index funds, the small amount of 2-5% that is kept aside as cash balance, shows up in the tracking error calculations. Third reason is, the inability to buy or sell the underlying index stocks due to sudden market fluctuations, this impacts the tracking error.

Findings and Recommendations

This study aimed to explore the world of Passive Investments and the findings reveal several key insights. The total AUM of India is rupees 69,32,959 crore indicating a very strong hold of the passive funds and ETFs in the stock market. The study further discusses how the TER (Total Expense Ratio) or the cost of maintaining an active fund is generally higher than maintaining passive funds. The TER of active funds in India is between 0.5 & 1%.

Highlighting the challenges faced while managing and accessing risk profile of index funds in India. The risk profile ratio is difficult to maintain since index funds track their benchmark index exactly.

Further, in order to include more than top 250 stocks for creating a diversified portfolio, SEBI needs to improve their asset management system to ensure complete disclosure of information from Small – Cap companies and segregating small cap stocks to monitor and control market volatility.

Concluding the study by analyzing the Tracking Error, in India the error is not more than 0.5% in most funds, that index funds closely monitor the index. Whereas, in global markets, especially U.S. Index Funds track the index better, by holding the tracking difference at 0.2%

Limitations

While this study provides valuable insights into the field of passive investments, certain limitations must be acknowledged. The data provided throughout the study has been taken from official websites of the respective countries (India and U.S.) and also from articles of renowned organizations.

The global stock market includes countries such as U.S. and China, but due to lack of resources, only the data of U.S. markets is included.

Conclusion

In conclusion, our study reveals that passive investments strategies deliver competitive returns while keeping the cost and risk minimum, motivating consumers to invest and to inculcate the habit of saving. This research thus underscores the enduring effectiveness of index-based investing achieving long term financial goals especially during periods of market volatility.

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Morningstar