



# An Investor's Guide To Exchange Traded Funds

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## ABSTRACT

The paper takes a descriptive approach towards a novel financial instrument – Exchange Traded Fund or ETF in the Indian market. In spite of its introduction in 2002, there has been very limited acceptance of this simple, low-cost and affordable financial instrument among the Indian retail investors. Previous literature survey has highlighted the usefulness of this product as the best first-time investment option for new retail investors. This is even better than index funds because of low cost, real-time pricing and easy liquidity. The paper further examines the difference of this product from mutual funds and index funds. It also ponders over relevant issues involved in ETF investing like taxation, dividend, expenses, relevant risks and impact on financial market.

**Keywords:** Exchange Traded Fund, ETF, index fund, authorised participant, mutual fund

## 1. INTRODUCTION

The beginning of the twenty-first century has ushered in a large number of innovative products in the financial market – both in India and the world. While the emergence of these novel financial products has definitely broadened the market and has attracted a large number of new investors, it has introduced a quantified element of risk in the financial system. The global economic crises in 2008 that started with the sub-prime bond market crisis in the United States of America has given a big warning to the investors of these novel financial products.

However, all the new financial products are not as risky as the sub-prime bonds and in fact some are better than the existing lot of instruments like equity shares and equity mutual funds that we are used to. In this article, we are going to discuss and learn about one such product that is gaining popularity among the ordinary investors – Exchange Traded Funds or ETFs.

ETFs represent a basket of securities (usually indices) that are traded, like individual shares, on an exchange. Unlike regular open-ended mutual funds, ETFs can be bought and sold throughout the trading day like any stock. ETFs have lower cost of transactions and annual changes compared to index funds. ETFs are generally considered a safer product for risk averse and first time investors who want market linked returns.

ETFs first came into existence in the USA in 1993. But

It took several years for them to attract public interest. The first ETF in India was Nifty BeEs (Nifty Benchmark Exchange Traded Scheme) based on Nifty 50 which was launched in January 2002 by Benchmark Mutual Fund. Its symbol on NSE is 'NIFTYBEES'.

Both NSE and BSE has presently many ETFs listed that are linked to different assets like market equity indices, sectorial indices, global indices, gold, fixed income papers and bonds.

## 2. UNDERSTANDING AN ETF

ETF units, unlike Mutual funds, are not sold to the public for cash. Instead, the Asset Management Company (AMC) that sponsors the ETF (Fund) takes the shares of companies comprising the index from various categories of investors like **Authorized Participants (AP)**, **large investors (LI)** and **financial institutions (FI)**. In turn, it issues them a large block of ETF units. Since dividend may have accumulated (not yet disbursed) for the stocks, a cash component to that extent is also taken from such investors. In technical terms, a large block of ETF units called a “**Creation Unit**” is exchanged for a “**Portfolio Deposit**” of stocks and “**Cash Component**”.

The number of outstanding ETF units is not limited, as with traditional mutual funds. It shall increase if investors deposit more shares to create ETF units, or it may reduce any day if some ETF holders redeem their ETF units for the underlying shares. These transactions are conducted by sending creation or redemption instructions directly to the Fund. This happens in the Primary Market.

The Portfolio Deposit closely approximates the proportion of the stocks in the index together with a specified amount of Cash Component. This “in-kind” creation / redemption facility ensures that ETFs trade close to their fair value at any given time.

The investors (AP, LI or FI) may prefer to hold the creation units in their portfolios. Or they can break-up the creation units and sell on the exchanges (secondary market); from where individual retail investors may purchase and sell them just like any other shares. This happens in the Secondary Market.

The next figure sourced from NSE explains this process Lucidly.

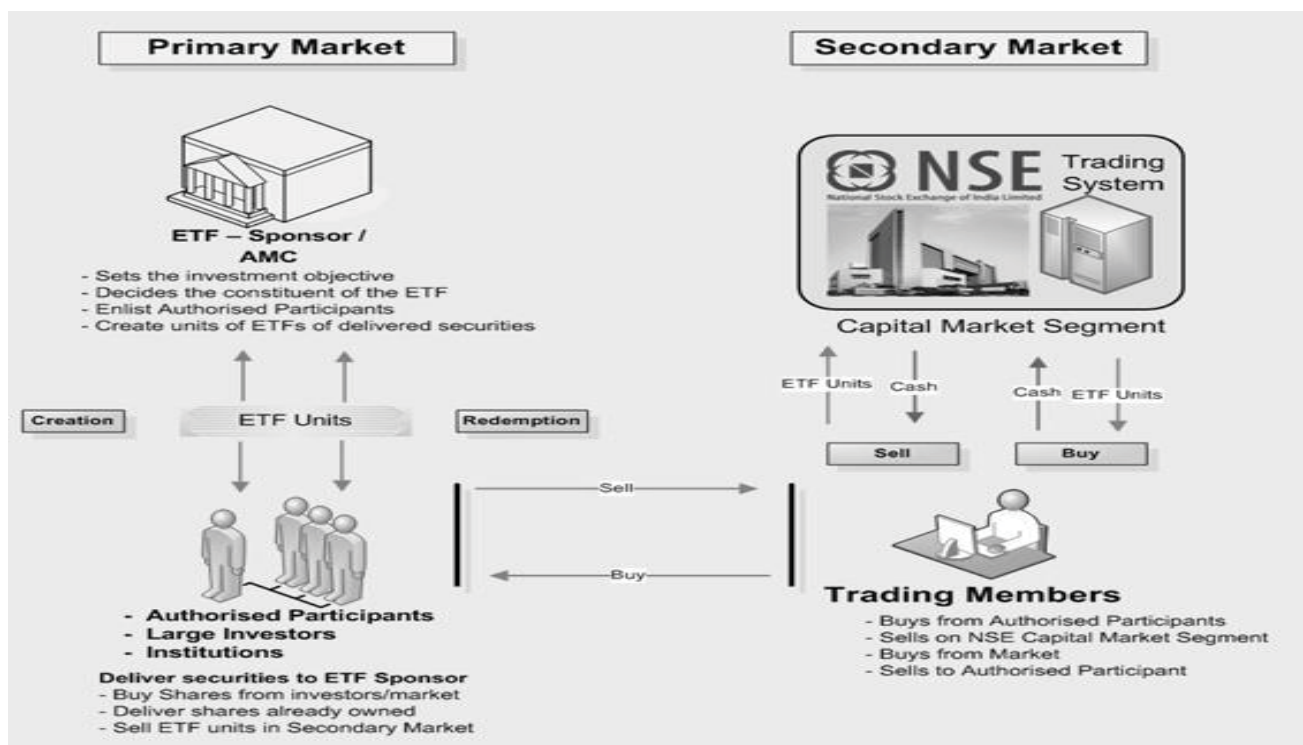


Figure 1: Generation and Trading in ETFs

Source: www.nseindia.com

ETF units are continuously created and redeemed based on investor demand. Investors may use ETFs for investment, trading or arbitrage. The price of the ETF tracks the value of the underlying index. This provides an opportunity to investors to compare the value of underlying index against the price of the ETF units prevailing on the Exchange.

When the value of the underlying index is higher than the price of the ETF, the investors (AP, LI or FI) may redeem the units to the Sponsor in exchange for the higher priced securities. Conversely, if the price of the underlying securities is lower than the ETF, the investors may create ETF units by depositing the lower-priced securities. This arbitrage mechanism keeps the ETF price close to the NAV.

The next table gives a brief snapshot of daily market activity of India’s oldest ETF NiftyBEES. It tracks the Nifty50 index. Its price is close to its NAV. It is traded daily in NSE just like an ordinary share.

Table 1: Market activity (18th Jan, 2021) of Nifty BEES

Underlying Asset	Closing Price	VOLUME	VALUE (Rs. Lakhs)	NAV	18-Jan-2021	52 Week High	52 Week Low	1 Day % Chng	1 Year % Chng	1 Month % Chng
Nifty 50	156.38	19,66,764	308,801,616	156.36	169.7	81	-0.24	21.26	10	

Source: www.nseindia.com

Sometimes, investors confuse an ETF with an **Index Fund**. ETFs and Index Funds both are passively managed. But Index Funds operate like mutual funds and are priced at the close of the trading day based on the NAV of the underlying securities, whereas ETFs are priced to the market throughout the trading day. So, ETFs are easier to buy and sell. Secondly, ETFs are available only on stock exchanges. Hence, demat account is compulsory. Whereas for an Index Fund, an investor need not have a demat

account and may buy or sell the Units of an Index Fund directly from the mutual fund in small amounts. Thirdly, ETFs don't try to outperform their corresponding index, but simply replicate the performance of the Index.

### 3. LITERATURE REVIEW

In this section, a broad review was conducted to find out the opinion and analysis of other researchers on this new instrument. These were mainly conducted in the Indian context.

**Bhatia (2018)** suggests that first-time retail investors should begin investing with ETFs which track indices like Nifty 50 index. ETFs can be bought on the stock exchange or directly from the fund. An investor can otherwise follow the cash subscription method wherein they pay directly to the fund for purchasing the units.

**Bhattacharya and O'hara (2020)** consider ETFs as one of the most important financial innovations of recent times. ETFs have opened up new asset classes that formerly permitted only privileged entry by high net worth investors.

But ETFs are causing systemic changes that arise from their passive, basket structure. A second set of systemic issues concerns the role of ETFs in market disruptions. As ETFs are continuously evolving and their rules, there is much to learn about the effect and role of ETFs in the global financial markets.

**Ghosh (2012)** considers ETFs as a cost efficient mode of investment in stock indices and selected commodities. The paper considers ETFs as cost efficient investor friendly investment vehicle without human bias. Although many Indian investors think active portfolio management generates higher return, but this leads to injection of human bias and perception. The risk element (both systematic & unsystematic) also increases in managed

and concentrated portfolios. As the retail investors don't have access to relevant knowledge and information, so ETFs are a better option to replicate better risk adjusted return. He also recommends more customer awareness programmes by AMCs.

**Kurian (2017)** in his study evaluates the presence and performance of Indian Index ETFs. It has found out that Index ETFs on most counts have been performing better than the common benchmark CNX, Nifty and Sensex. Even in huge downturns in the market, ETFs managed to give out lesser negative returns when compared to benchmark for the same period. Hence for a small investor looking to make a less risky investment, these instruments offer an ideal way of diversification.

**Maheshwari (2018)** has observed that the world over ETFs are favoured by global pension funds for long term investment and 'Buy side advisor'. In India, the era of pension funds have just begun. The operational inconveniences and absence of buy side advisors has not helped the situation either. In comparison, direct index funds can give similar returns at a similar cost and more convenience. Hence ETFs have some way to go till they become as popular as the mutual funds.

**Manda and Polisetty (2019)** in their paper highlight the growing importance of passive investing products such as Index mutual funds and Exchange Traded Funds (ETFs).

As stock exchanges are designing and offering a variety of indices, more AMCs are offering newer ETF products. Even Governments are using the ETF route to achieve divestment targets. According to the authors, the penetration of ETFs is low in India because of lack of product understanding and lengthy transaction process. They suggest having investor camps, simplified products, lower tax treatment and lower expenses to encourage more investors to try ETFs.

**Sekaria and Deora (2018)** ponder upon the debate on whether Active fund managers have the potential to outperform Passive funds in the global context. They feel that Indian investors really need a blend of both. There is a need for adopting both styles through a 'Core & Satellite' approach to portfolio management in order to mitigate the risk of underperformance.

**Umarani and Deepa (2014)** have observed that in India, trading in ETFs has been quite limited relative to the U.S. and Europe. They think that Regulators need to tread carefully to manage risks and yet not impose unnecessary regulation.

#### 4. OBJECTIVES OF STUDY

ETFs have gained popularity across the developed world but not so much among the retail investors in India. Hence this study attempts to make the product familiar and easy for the small retail investors to understand and invest. There is a paucity of data on this product because of low volumes and lack of understanding. Most of the information have been sourced from internet and website of BSE and NSE.

This study has two objectives:

- ⑨ To understand the basic concept of ETFs in present form
- ⑨ To understand the issues involved with regard to investing in ETFs in the Indian market

## 5. MARKET CLASSIFICATION

An ETF, or exchange traded fund, is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. The following are the **broad types** of ETFs currently available to investors in India that can be used for income generation, speculation, price increases, and to hedge or partly offset risk in an investor's portfolio.

**Bond ETFs** might include government bonds, corporate bonds, and state and local bonds – called municipal bonds.

**Industry ETFs** track a particular industry such as technology, banking, or the oil and gas sector.

**Commodity ETFs** invest in specified commodities including crude oil or gold.

**Currency ETFs** invest in foreign currencies such as the Euro, Yen or US dollar.

**Inverse ETFs** attempt to earn gains from stock declines by shorting stocks. Shorting is selling a stock, expecting a decline in value, and repurchasing it at a lower price.

## 6. ADVANTAGE OF ETFs

There are many types of investors in the capital market. The unique structure of ETFs makes it popular to all types of investors – retail or institutional, long-term or short-term.

ETFs are quite similar to index mutual funds. They provide exposure to an index or a basket of securities that trade on the exchange like a single stock.

- ⑨ They allow long-term investors to diversify portfolio at low cost and insulate them from short-term trading activity due to the unique “in-kind” creation/ redemption process.
- ⑨ As the required initial investment is low, find it simple and convenient to buy/sell in small quantities.
- ⑨ Since an ETF is listed on an Exchange, costs of distribution are much lower and the reach is wider. These savings in cost are passed on to the investors in the form of lower investing, processing and holding costs.
- ⑨ ETFs protect long-term investors from inflows but flows of short-term investors. This is because the fund does not incur extra transaction cost for buying/ selling the index shares due to frequent subscriptions and redemptions.
- ⑨ While redemptions of Index fund units take place fixed NAV price (usually end of day), ETFs offer intra- day purchase and sale on the Exchange at market price.
- ⑨ They provide investors a fund that closely tracks performance of an index (also called index tracking) throughout the day.

- ⑨ Mutual fund schemes usually trade at substantial premia or mostly at discounts to their NAV. But as ETFs allows creation of new units and redemption of outstanding units directly with the fund, thereby ensuring that ETFs trade close to their actual NAVs.
- ⑨ Tracking error, which is divergence between of ETF and underlying Index, is generally low as compared to a normal index fund due to lower expenses and the unique in-kind creation/redemption process.
- ⑨ Some international ETFs track the performance of well-known indices like NASDAQ, NYSE, Nikkei etc. This presents a unique opportunity to retail investors to have an exposure to these otherwise unreachable markets for them.
- ⑨ ETFs help FIIs, Institutions and Mutual Funds have easy asset allocation, hedging, equitising cash at a low cost.
- ⑨ They enable arbitrageurs to carry out arbitrage between the Cash and the Futures markets at low impact cost.

Now is the time to understand the basic differences among ETFs and common shares and Mutual Funds.

**Table 2: Comparison between ETFs, stocks, and mutual funds**

	ETFs	Stocks	Mutual Funds
What is it?	A basket of securities that tracks an underlying index or sector.	Single security that signifies ownership in a company.	An investment avenue where funds are pooled together and invested in different asset classes based on the objective of the fund.
Risks	A diversified approach to an asset class. Carries market-related risks though.	Risks are more since the performance of the stock depends on that of the company.	Diversified exposure but carries market-related risks.
When can you trade?	ETF units can be traded throughout the day.	Stocks can be traded throughout the day.	Mutual fund trades are conducted only once a day after the market closes.
Control	Less control than stocks but more than mutual funds.	The maximum control over the investment.	The least control over the investment.

<https://groww.in/blog/beginners-guide-to-etf/>

## 7. MAJOR ISSUES IN INVESTING

ETFs can be used both by the APs and the retail investors to make money at lower risk through the primary and secondary market respectively.

However, it has been a very slow start to ETF investing in the Indian market. The following data from BSE shows that volumes and value of traded have been negligible up to 2015-16.

Volumes increased during 2016-

19. But volumes again dipped in financial year 2019-20. In 2020-21, the ETF market is yet to recover from the effect of Coronavirus pandemic and resultant economic contraction.

**Table 3: Trend in ETF investing in BSE**

Financial Year	Avg. daily Volume (in figures)	Avg. daily Turnover (in Rs. Lakhs)	Avg. daily Trades (in figures)
2002-03 (from Jan13_03)	20,577	6.73	78
2003-04	13,976	6.24	24
2004-05	23,677	14.46	11
2005-06	916	1.35	13
2006-07	123	0.22	4
2007-08	4,591	6.21	36
2009-10	18,733	150.43	357
2010-11	72,099	419.1	1179
2011-12	45,788	737.56	2719
2012-13	56,645	937.63	2381
2013-14	1,94,254	2456.07	2987
2014-15	2,18,166	632.43	3417
2015-16	3,38,714	2899.41	1696
2016-17	10,64,672	3905.29	2021
2017-18	14,44,861	6132.17	7043
2018-19	19,13,317	4785.81	2179
2019-20	15,87,581	2320.12	23514
2020-21 (upto Jan18_21)	9,75,210	1797.82	20022

Source: www.bseindia.com

Let us now look at the major issues investors must ponder before making any investment in ETFs.

**Expenses:** It is known that ETFs provide lower average costs as only brokerage needs to be paid. Some brokers even offer no-commission trading on certain low-cost ETFs reducing costs for investors even further.

However, not all ETFs track an index in a passive manner. There are also actively-managed ETFs, where

portfolio managers are more involved in buying and selling shares of companies and changing the holdings within the fund. Thus an actively managed fund will have a higher expense ratio than passively-managed ETFs. So investors must know how the fund is managed, the resulting expense ratio, and weigh the costs versus the rate of return before making any



investments.

**ETF Composition:** An indexed-stock ETF provides investors with the diversification of an index fund as well as the ability to sell short, buy on margin, and purchase as little as one share since there are no minimum deposit requirements. However all ETFs are not equally diversified like sectorial ETFs. Some may concentrate heavily on one industry, or a small group of stocks, or assets that are highly correlated to each other.

**Dividends:** ETFs provide retail investors with capital gains besides they also benefit from companies that pay dividends. ETF shareholders are entitled to a proportion of the profits, such as earned interest or dividends paid, and may get a residual value in case the fund is liquidated.

**Market Depth:** Many new ETFs have been created lately resulting in low trading volumes for some of them. This results in investors not being able to buy and sell shares of a low-volume ETF easily, just like an illiquid stock.

**Taxes:** An ETF is considered more tax-efficient than a mutual fund since most buying and selling occurs through an exchange and there is no need for redemption for retail investors. Redeeming shares of a fund can trigger a tax liability like in close-ended mutual funds.

**Market Impact:** Experts have expressed concern over the influence of ETFs on the market and whether demand for these funds can inflate stock values and create artificial bubbles. Some ETFs use portfolio models that are untested in different market conditions and can lead to extreme inflows and outflows from the funds, having negative impact on market stability. Since the financial crisis of 2008, ETFs have played major roles in market flash-crashes and instability.

## 8. CONCLUSION

The principal objective of this paper has been to sensitize the retail investors about the utility of ETFs in the Indian capital market. It uses simple language to explain the concept and the process of its creation. The paper also differentiates the product from other common instruments like share and mutual funds.

The use of ETFs by the Indian government through Bharat22 ETFs to meet its divestment target has helped to make it somewhat popular among the masses. It has also given them some sort of assurance about the legitimacy of the product. However, because of low fees charged on the product, the brokers and sub-brokers do not find it appealing to market the same among its clients. This is one big reason behind the low turnover of ETFs compared to wholesale debt and equity markets.

However, a flagship index-linked ETF provides an ideal entry point for a new retail investor in the Indian capital market. It is also a prudent investment vehicle for risk-averse

investors who want to earn something more than what is offered by bank fixed deposits with ample liquidity.

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