SWATANTRA

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Market Linked Returns At Low Cost Make Index Funds attractive

These funds almost completely eliminate fund-manager risk inherent in mutual fund schemes

Partha Sinha | TNN

Very often investors are faced with the issue of wanting to invest in the stock market but are afraid of the risks associated with it. One of the ways to lower this risk of stock market exposure is to identify those stocks which have, historically, shown lower volatility compared to other stocks and invest in those stocks.

Another way to lower stock market risks is to invest through the equity mutual fund route. In mutual funds, for a small fee, experienced fund managers and analysts, take care of investors' money and try their best to optimize their profits after taking care of the risks associated with such investments. Within the mutual fund space also there is a category of funds, called the index funds, which offer even lower risks of investing in the stock market and also at a relatively lower cost.

Index funds are those mutual fund schemes in which the fund managers build their portfolios which replicate the constituent of an index which is called the benchmark index for that fund. For example, if an index fund replicates Index A in which Stock A has 10% weightage and Stock B 9%, and so on, with 30 stocks in total, the fund manager for the index will also have Stocks A and B and the rest 28 stocks in his/her portfolio with exactly the same representation. So in the market, the day the Index A rises 1%, the index fund portfolio will also rise 1%. The day the index falls 1%, the index fund portfolio will also fall 1%. There could be some very minor deviations from this rise and fall in the index, which is called tracking error.

This is called passive index fund investing compared to regular equity fund investing where the fund manager tries to buy and sell stocks in the portfolio in order to maximize returns.

Because of the passive nature of investing, compared to active fund management, costs for these funds are also low. "Index funds tend to be more cost-effective than actively-managed funds and can be a transparent option as the investment is intended to mimic the underlying index," said Koel Ghosh, head - business development, South Asia, S&P Dow Jones Indices. "As the index is often constructed by an independent index provider, the rules and the construction are typically published and made available for investors to access. This transparency is intended to helps investors understand the investment strategy," Ghosh said.

There are specialized agencies around the globe which launches and maintains specialised low-volatility indices which could be used as benchmark index for some index funds. According to a note from S&P Dow Jones Indices, an index which represents low volatility stocks and "rebalances quarterly to reflect the least volatile 20% basket (of stocks), weighted in terms of their volatility has been seen to have generally outperformed traditional market cap indices, because of the downside protection provided in adverse market conditions".

ILLUSTRATIONS: DEBASISH SARMA

On the question of how much of an investor's portfolio should be invested in index funds, Ghosh said that an investor's investment allocation is usually based on the individual's risk-return profile. "Many investment strategies employ a core satellite strategy wherein either an active strategy or a passive strategy can constitute one's core strategy and the other satellite. This approach is intended to allow an application on both active and passive styles to achieve investment goals," Ghosh said.

According to a top official at a large domestic fund house, it depends on what exactly the investor is looking for from an index fund. "If the investor is happy with a return that is equal to the index return, he/she can put all his/her equity portfolio into index funds," said the official.

NEXT EDITION

In our next edition we will discuss how using the SIP route of investing, one can manage his/her future liabilities which could be short term, medium term or long term.

GURU SPEAK

"For wealth creation in the long term, what matters is not timing the market, but the time in the market

Anonymous

MIPs can give the 'growth kicker'

Warren Buffett, the globally celebrated investor and one of the richest persons in the world started investing when he was just 11. Yet, he thinks he was late in starting to invest. Not every youngster ventures into investing early in life. Swatantra in TOI receives mails from young, would-be investors, seeking help about how to start and where to start. Through this occasional column we will connect experienced financial planners who will handhold investors who are below 25 years and need help for investing.

QUERY 1: I am 17 years old. I want to grow my current corpus of about Rs 25,000-30,000 in about a couple of years (short period) in any alternative method other than term deposits in banks.

Tarun Nalam

QUERY 2: I am 20 years old, a student of chartered accountancy (CA) course. I am doing my internship (articleship) for three years during which I get monthly stipend. I'll get Rs 1,500 per month in the first year, Rs 2,000 in the second year and Rs 2,500 in the third year. After my CA, I want to pursue higher education. I can save the whole of my stipend and want to invest in mutual funds through the SIP route so that I can have some corpus for further studies. I will be able to invest Rs 2,000 per month for the first two years and Rs 3,000 per month in the third year with moderate or moderately high-risk funds. I am a first time investor so I want to seek your help as to whether it is a good proposition for me and if yes what are the options available.

Aayush Bajaj

Naresh Pachisia advices:

Normally, at such young age, presuming one has no financial responsibilities, both th investors could have aspired for higher returns to create wealth over the long run. However, Tarun has specifically mentioned that his in-

YOUNG & SMART

tended time horizon is just 'a couple of years' and he wants to play 'safe'. Aayush also wants to fund his higher education after three years from his savings. Keeping in mind we have the following to suggest:

Interest rates in India are gradually coming down. In such a scenario, investing in 'fixed return instruments' like bonds, is quite 'safe', with an opportunity for generating higher than normal returns as bond prices appreciate when interest rates come down.

Simultaneously, with a continuously improving domestic macro-economic scenario and GDP expected to grow at over 7%, and a relatively stable global economy, we expect corporate performance bottoming out now and move into a growth trajectory soon, aided by low base effect. Fall in stock markets over last one year has brought valuations to long term average, leaving room for growth. In such a scenario, having a small portion of your savings invested in equities as an asset class could give you higher returns over the next two years.

Keeping the above in mind, we recommend investing in mutual fund MIPs (growth option) to both, Tarun and Aayush. Although MIP stands for Monthly Income Plan, these are asset allocation funds where about 80-85% of your money is invested in the safety of fixed return instruments, while the balance 15-20% is invested in equities with an objective to provide a 'growth kicker' to your return on investments. With both these asset classes expected to do well over the next couple of years, we recommend both investors to invest an equal amount in two MIPs to reduce risk with diversification.

- Tarun can invest lump sum Rs 10,000-20,000, divided in to two MIPs.
- Aayush can make SIPs of Rs 1,000 per month in two MIPs for the first two years, increasing it to Rs 1,500 per month in the third year.

Naresh Pachisia is MD, SKP Securities

INVESTOR QUERY

QUERY 1: SOON AFTER THE GOVERNMENT REDUCED RATES OF RETURN IN SMALL SAVINGS INSTRUMENTS INCLUDING IN SENIOR CITIZEN FD SCHEMES, WE RECEIVED SEVERAL QUERIES FROM ANXIOUS INVESTORS, ESPECIALLY FROM SENIOR CITIZENS, IF FDS IN WHICH THEY HAD INVESTED EARLIER AT THE RATE OF 9.3% PER ANNUM, WILL ALSO BE REDUCED TO THE NEW RATE OF 8.6%.

Reply: According to people at post offices, banks and also financial advisors, an FD is a contract between the person who's investing in the FD and the institution that is accepting the FD. Under this contract the terms and conditions set at the start of the FD can not be changed unless such terms for change were there in the contract in the first place. The terms and conditions for the FDs under senior citizen schemes do not have any scope for change, including the rate of interest. So if you had invested in a senior citizen scheme before April 1, 2016, the rate of interest at which you started your FD will not change. However, when that FD matures and you want to reinvest the amount in the same instrument, in that case you will get the new rate, which is 8.6% now.

QUERY 2: THERE ARE INVESTORS WHO BELIEVE THAT WHILE INVESTING THROUGH THE SIP ROUTE HE/SHE CAN INVEST AT VARIOUS LEVELS OF THE FUND'S NAV WHICH AVERAGE OUT OVER THE LONG TERM. HOWEVER, THEY BELIEVE THAT AFTER CHOOSING A THE RIGHT FUND, INVESTING PERIODICALLY AT TIMES WHEN THE NAV IS RELATIVELY LOW, WILL GIVE MORE UNITS THAN INVESTING THROUGH A REGULAR SIP. THIS WAY BY INVESTING JUDICIOUSLY, THE INVESTOR WILL GET THE BENEFIT OF INVESTING AT A LOWER LEVEL ALTHOUGH A LITTLE MORE EFFORT IS NEEDED ON THE PART THE INVESTOR. IS THIS A GOOD APPROACH?

Reply: Theoretically this type of a strategy makes perfect sense for an investor for the long term: Enter at a low and enjoy the benefits of low NAV of the fund as the NAV grows over time. However, for such a strategy to succeed the investor would need to time the market perfectly. The reality is that even the best of fund managers around the world and over time have failed, time and again, to time the market perfectly. That's why SIP is a more accepted way of investing than trying to time the market.

WHAT ARE THE ADVANTAGES OF INVESTING THROUGH INDEX FUNDS?

LOW COST
Compared to actively managed funds which charge between 1.5% and 2.75% per annum, costs here are 1/10th or even less than that. Exit load in these funds is also very low.

NO SCOPE FOR REGRET ABOUT THE CHOICE OF FUNDS
If you choose an actively managed fund and the same performs badly compared to other funds, you may feel bad about your choice. If you choose to invest through a passively managed index fund, it will perform as per the performance of the index and there is no gap between the expectation and the actual performance.

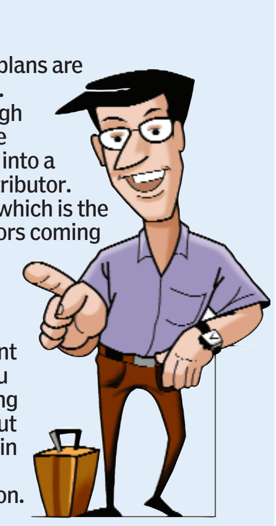
NO FUND MANAGER RISK
Index funds eliminate the risk of performance of a fund manager that you take in case you invest through an actively managed fund.

NO NEED TO CHOOSE A FUND, STOCKS ETC
Investors investing in an index fund do not need to select the right fund that is suitable to his/her risk profile. Here all that he/she has to decide is if he/she has the appetite for index-related risks. The same applies in case an investor wants to invest directly in stocks compared to through an index fund.

DEMYSTIFIER

WHAT ARE REGULAR AND DIRECT PLANS IN MUTUAL FUND INVESTING?

Swatantra Kumar explains: Regular plans and direct plans are two approaches to investing in mutual fund schemes. Investors investing through the regular plan go through mutual fund distributors or agents, while as the name suggests, investors under direct plans invest directly into a scheme, without the intervention of any agent or distributor. Under direct plans investors are charged lower cost, which is the agent's commission, a fee which is charged to investors coming through the regular plan. It is true that lower fees under direct plans are added to investors' total returns, but there is one major disadvantage to this mode of investing. Under regular plans, if you are investing through an experienced and dedicated agent or distributor, the chances are that in the long run you will have less chance of a regret of investing in a wrong fund. While some analysts profess direct investing, but if you are not an experienced investor with expertise in choosing the right plans for your financial goals, for some extra fee, a regular plan may be the better option.



Send in your suggestions, queries to **info@beswatantra.com**.
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