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TalkingPoints

Charting a Course for the Continued Rise of Passive in India

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While India has taken to passive investing in a big way, there are still a few hurdles preventing serious growth. We sat down with Tyler Carter, Associate Director, Global ETF Strategy at S&P DJI, to explore how passive's rise in other markets could help inform a path forward in India.

1. How large is the passive market in India today and what has its growth trajectory looked like in recent years?

Tyler: The passive exchange-traded fund (ETF) market in India reached USD 25 billion in 2020. While this is modest compared with more established markets, the growth trajectory has picked up significantly in recent years; the 10-year CAGR sits at 49%, which is over twice the annual growth rate of the global ETF market overall. As we have seen in more developed markets, the ETF sponsors that establish a footprint early on tend to remain at the forefront as the market grows.[1]

2. Some investors in India still prefer active management despite increased interest in and availability of passive strategies. What have been some of the influences of a shift to passive in other emerging markets?

Tyler: Passive is certainly making inroads. In just the past two years, passive ETFs have grown from 2% of the Indian mutual fund industry to over 9%. The driver of this appears to be the same driver that exists in other markets that have seen a similar shift: potential value. Passive investing has historically provided a cheaper alternative for gaining broad exposure to the markets than active management. Despite often lower costs, passive access to markets hasn't necessarily come at the expense of returns. For example, our headline index in India, the S&P BSE 100, has outperformed over 82% of active funds over a five-year period.[2] (Note, however, index performance is not the same as fund performance. Index performance does not account for management fees, transaction costs or other expenses.) Typically, if investors start to see that type of outperformance, the shift to passive tends to occur naturally. Our biannual S&P Indices Versus Active Funds (SPIVA®) Scorecards show that, over the long-run, passive outperforms active. That evidence can be compelling for investors looking to limit costs while keeping long-term goals in reach.

1 Source: S&P Dow Jones Indices LLC and Morningstar.

2 Source: Jain, Akash and Arpit Gupta, "SPIVA India Year-End 2019 Scorecard," S&P Dow Jones Indices LLC, 2020.

3. Liquidity has been a big problem in India historically. Can you talk about the effectiveness of liquidity enhancement programs where secondary market transactions are persistently low? What have similar markets done to boost liquidity that we could also consider?

Tyler: ETF market makers exist to help create an efficient, liquid trading market. Liquidity enhancement programs exist globally and have historically proven effective in developing liquidity for new and lesser-known products. These programs are really only one piece of the liquidity puzzle though. Something as simple as analyst coverage and increased communication to the target investor base can usually go a long way in helping to build and sustain liquidity.

4. India launched its first bond ETF last January, comprising government-backed companies. Its liquidity held up during the COVID-19 crisis, even as investors shunned corporate debt by other issuers. Is this increased liquidity for bond ETFs a trend that you've observed in other markets?

Tyler: Absolutely. Across every region, bond ETFs have seen increasing liquidity. This evolved naturally, as ETF use across the full portfolio range has become more common. Liquidity surrounding bond ETFs has always been questioned, but recent events in the U.S. demonstrated that bond ETFs have the necessary liquidity, and in fact, they served to keep markets efficient. As primary bond markets froze in Q1 2020, fixed income ETF volumes surged to record levels.[3] In that sense, it wasn't an issue of liquidity drying up but instead increasing to the point where it propped up primary markets.

5. What are your thoughts around potential applications for bond ETFs? What should be kept in mind as India looks to expand its bond ETF industry over time?

Tyler: As the market matures further, we would expect to see more and more bond ETFs making their way into model portfolios as well as the hands of institutional and individual investors alike. Over time, we may also see elements of bond ETFs start to make their way into multi-asset ETFs in India. We've already seen this trend in the U.S., and the index framework enables this approach in other markets. It should also be noted that global fixed income trading has seen a large pickup in recent years, setting a new record for flows in 2019 that the market is currently on pace to break in 2020.[4]

6. Can you tell us a little bit about recent innovations in ESG and factor indices? What do these indices track and what's driving demand for these index innovations in other markets?

Tyler: ESG has become a core focus for us at S&P DJI and that is fundamentally driven by investor demand. In the past couple years, we have incorporated ESG data and principles into some of our most well-known indices such as the S&P 500® so that investors looking to maintain traditional core exposures can do so while now adhering to their ESG values. In the case of the S&P 500 ESG Index, we start by excluding tobacco, controversial weapons providers, thermal coal producers, and those companies not in compliance with the UN Global Compact.[5] We have then developed S&P DJI ESG Scores, a very robust ESG dataset built on the SAM Corporate Sustainability Assessment (CSA) that target companies in the top 75% of market cap within each GICS® industry group category, while excluding the companies in the lowest 25% of scores. The remaining companies are then weighted by float-adjusted market capitalization. The result is an index that is meaningfully different than the S&P 500 and much more aligned with ESG investor values.

On a similar note, we continue to develop single and multi-factor indices to meet investor demand. Factor indices sit across a wide variety of investment objectives, but in general, they are being designed to replicate some of the more quantitative investment strategies that were traditionally accessed on the active investment side. Through developing these strategies in a passive format, we can offer a wider audience of investors a comprehensive set of tools that they may not have had access to previously.

3 Gunter, Evan M and Brian D Luke, "Credit Trends: How ETFs Contributed To Liquidity And Price Discovery In The Recent Market Dislocation," S&P Global Ratings, 2020.

4 Source: S&P Dow Jones Indices LLC and Morningstar.

5 Source: Naqvi, Mona, Reid Steadman, and Daniel Perrone, "The S&P 500 ESG Index: Defining the Sustainable Core," S&P Dow Jones Indices, September 2020.