

## INSIGHTS

# India ETFs: On a long-term elevated plane?

By Piyasi Mitra | Apr 06, 2023



**Unruffled by worldly turmoil, India's stock market continues to grow. *Piyasi Mitra* considers ETFs that offer access for European investors.**

Sitting in a "bright spot in the dark horizon" and unruffled by worldly turmoil like a yogi. That's just a picture of the modern Indian economy as painted by IMF forecasts, World Bank projections or JP Morgan economic trend reports.

If a Morgan Stanley report is anything to go by, becoming the world's third-largest stock market by the end of this decade would be a natural progression for India. The country's mutual fund industry gained a huge fillip, with asset values owned by retail investors increasing by 9.3% to US\$282.9 billion (€264 billion) this January, according to the Association of Mutual Funds in India. Data shows institutions invest predominantly in liquid, debt-oriented strategies, exchange-traded funds (ETFs) and funds of funds, whereas individual investors typically hold equity-oriented schemes.

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The Indian market is historically trading at one of the highest premiums compared to other emerging markets, a report from India Capital Growth Fund points out. The facilitators of the country's resilient economy are multifold, says the asset manager: robust government tax collection; a revival of capital expenditure in the private sector and real estate realms; good consumer appetite, despite inflation; and a stable currency, buoyed by foreign reserves worth at least \$560 billion.

The list includes rising inward remittances and exports of IT services surpassing the bill that India pays to import oil (which bridges the current account deficit). And there is steady buying from domestic institutional investors and vibrancy among domestic retail investors. Data from Ocean Dial Asset Management and Bloomberg showed that retail investors absorbed roughly \$17 billion of what foreign institutional investors sold last year.

"2023 could be a year of modest returns fuelled by earnings growth, but a possible correction in valuations. The valuation premium over emerging markets is showing signs of narrowing, thanks to China's reopening," reports India Capital Growth Fund, underscoring the notion that India's increasing share in the MSCI emerging market index could result in higher allocations from passive funds should emerging market funds receive inflows. This is the "joker in the pack", according to the firm.

A key driver is a better return on equity, which stems from India's increasingly diversified market and companies that are becoming more capital-efficient.

"The focus is on individual stock valuations at a portfolio level, rather than concerns on the global macro front or market valuations," says the fund manager. "Although absolute returns on FY24 [full-year 2024] earnings appear moderate, the big returns will come as we move towards FY25 earnings, with high earnings growth likely to drive returns."

The fund manager's largest sector exposure is on financials where there is a low risk on credit quality for at least the next two years. Credit growth is trending in double digits, and banks were described as being well-capitalised.

This is followed by materials, consumer staples and IT services sectors. Healthcare, utilities and industrials are among those sectors where the asset manager is underweight.

## **Indian ETF with the "lowest fees"**

Investors can access the broad Indian stock market through ETFs, charging annual total expense ratios between 0.19% and 0.85% p.a.

Domiciled in Ireland, the Franklin FTSE India Ucits ETF manages assets worth \$217 million and tracks the FTSE India 30/18 Capped Index.

Dina Ting, CFA, head of global index portfolio management, Franklin Templeton, says this ETF charges the “lowest fees” – 0.19% – across India ETF categories available in the European market.

“Low fees should be a deciding factor when choosing such India-focused funds, as compounded differences could increase up to 2% on the fee itself,” says Ting.

Franklin’s ETF provides deeper exposure versus peers to the mid-cap zone, or “sweet spot”, as Ting puts it, where investors may find more steady growth.

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“The mid-cap segment tends to be relatively less impacted by macroeconomic effects, such as currency fluctuations. Mid-cap stocks are generally more established leaders with better pricing power compared to small-caps and can see more growth than mega-caps.”

Reliance Industries, Infosys, Tata Consultancy Services, Axis Bank and Hindustan Unilever are some of the ETF’s top holdings. While returns were negative in a challenging 2022, they fared better than those of other countries, including the US.

On a relative basis, the fund also outperformed its benchmark, Ting remarks. “India’s stable political climate, youthful demographics, robust infrastructure development and rising tech innovations all bode well for fund performance,” she says, emphasising that single-country allocation can be a differentiator for well-diversified portfolios.

With €124.83 million of assets under management (AuM) across 113 holdings, the Amundi MSCI India Ucits ETF (Euro) replicates as closely as possible the performance of the MSCI India index in euros. With an ongoing charge of 0.80%, this ETF offers investors exposure to around 60 leading Indian stocks.

The iShares MSCI India Ucits ETF USD (Acc) has an expense ratio of 0.65%. It covers about 85% of the Indian stock market across large and mid-cap stocks.

Another ETF, which has £114 million (€130 million) of AuM and covers approximately 65% of free-float market capitalisation, is the Xtrackers Nifty 50 Swap Ucits ETF 1C. Offering a 0.85% total expense ratio, this ETF replicates the Nifty 50 index, providing diversified exposure to the top 50 blue-chip Indian stocks across 22 sectors of the Indian economy.

The effects of compounding are not to be underestimated, as many experts advise prioritising a low expense ratio as a criterion, provided other factors are nearly constant.

Lyxor MSCI India – the ETF provider recently acquired by Amundi and rated ‘neutral’ by Morningstar – comes with a “large and mega-cap bias” that renders it an imperfect tool to access the broader India equity market, points out Monika Calay, director of passive strategies at Morningstar. The fund tracks the performance of the market-cap-weighted MSCI India index covering 85% of the Indian equity market. By number, however, the fund tracks only 100 of the 4,000 listed Indian equities available across domestic exchanges.

A report by Cerulli Associates recently revealed that in India’s own mutual fund industry, investors are gravitating increasingly towards passive investing. According to the report, ETFs and index funds jointly led annual net flows in the market last year. “Furthermore, regulatory initiatives on fees and increasing usage of online platforms have put passive investing in the spotlight,” it said.

Overall, however, India remains a market where active managers have consistently shown that they can add value over standard index propositions, says Morningstar’s Calay. “Index strategies such as the Lyxor ETF should generally outperform during periods of market stress, but the upside offered by active managers during market rallies outweighs this over long periods, resulting in better risk-adjusted returns.”

### **Trendsetting with T+1**

India recently created stock market history by becoming the first country to move to a ‘T+1’ (‘trade-plus-one-day’) settlement cycle. In China, trade is settled on a T+1 basis in a few segments only.

Anil Ghelani, head of passive investments and products at DSP Investment Managers, a Mumbai-based firm offering India-focused ETFs and other investments, says: “Foreigners considering investing in Indian ETFs would benefit from increased operational efficiency, faster fund remittances, and ease of settlement under the T+1 cycle. This would also help market makers through reduced margin requirements and lower transaction costs.”

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Taking a leaf out of India’s book, the US Securities and Exchange Commission recently announced plans to move to T+1 settlement by May 2024. European banks and asset managers are also said to be contemplating T+1. Reuters has reported that a dedicated task force is studying the pros and cons of shortening the settlement cycle.

Effective May 1, India’s securities and commodity market regulator, the Securities and Exchange Board of India, has mandated that trades below approximately €3 million will be

routed through the exchanges and not directly with the manager. This move, Ghelani says, is likely to increase the liquidity of ETFs across exchanges.

He recommends that for broad market exposure, investors should go for traditional free float-based indices offering diversified exposure across prime sectors of the economy in the largest capitalised companies, such as the Nifty 50 or BSE Sensex. While there are small-cap indices too, few funds mirror them because of lower liquidity and because active fund managers have a better chance of generating alpha in that space, he adds.

Ghelani also says that many ETFs are now available on factor-based or smart beta indices, ranging from the simplest form of smart betas like equal-weight strategies or multi-factor, such as a combination of momentum, growth and value.

## **Elections, the budget and Adani**

Aneeka Gupta, director, macroeconomic research at ETF provider WisdomTree, points out that India's budget for the current fiscal year struck the right balance between fiscal consolidation and growth. Also in the spotlight is the 2024 national election that will decide the fate of prime minister Narendra Modi's government, which is looking to secure a third consecutive term.

"A 30% surge in capital spending to \$120 billion should encourage investment and capacity building ahead of the 2024 elections," says Gupta. "This could benefit the industrial, cement, banking and consumer sectors. On the flip side, the insurance sector could face headwinds amid the tax exemption removal on annual premiums over 500,000 Indian rupees."

There is an elephant in the room. Recently, American investment firm Hindenburg accused the Adani Group – an Indian multinational conglomerate founded by billionaire Gautam Adani – of "the biggest con in corporate history" through stock manipulation and "fraud" schemes over decades. The Adani Group dismissed the accusation as baseless.

Market sentiment has not soured. In a recent CNBC interview, veteran emerging market investor Mark Mobius opined that the controversy should be viewed in "isolation", highlighting that the "index has not suffered that much". Most global financial institutions, including Goldman Sachs, saw the allegation as an aberration and not serious enough to debilitate the wider Indian stock market. In similar tones, JP Morgan confirmed the eligibility of the Adani Group of companies for inclusion in its bond indices.

"Currently," says Gupta, "the Nifty 50 Index is trading at a fair valuation of 18.5x one year forward earnings per share. However, earnings could see further cuts ahead amid slowing global growth, partially offset by softening commodity prices."

In February, foreign funds boosted holdings of Indian stocks for six straight sessions amid the controversy – the longest streak since November 2022, according to Bloomberg data. Bloomberg Intelligence, which provided the data, also projects earnings per share for companies in the MSCI India Index to increase by 14.1% in 2023, better than most major markets. In the words of India Capital Growth Fund: "India needs to be seen from a longer-term perspective as an investment, not a trade."

The world's current perception of the Indian stock market is that while the falls seem temporary, the rise is permanent.