An Investor Education Initiative

MIRAE ASSET

Mutual Fund

by Mirae Asset Knowledge Academy

# Exchange Traded Fund

## Power of Passive Investment

# 01. Introduction to Exchange Traded Fund (ETF)

ETFs are types of Mutual Funds that aim to track the performance of a specific index such as NIFTY 50, NIFTY Next 50, NIFTY Bank etc. These ETFs can be based on indices tracking various asset classes like equity shares (NIFTY 50 ETF), bonds (10 year G-Sec ETF), Gold (Gold ETF), Tri-party Repo (Liquid ETF) etc.

In an ETF, the weight of all securities mirrors the weight of the securities in the underlying benchmark index. For example, if ABC Bank has a weight of 10.52% in NIFTY 50, a NIFTY 50 ETF will also have ~10.52% of ABC Bank by weight in its portfolio.

## Illustration :

**Index Constituents & Weight**

**ABC** (10%)

**DEF** (9%)

**KIL** (8%)

**XYZ** (7%)

**Index Provider**

**Fully Replicated ETF**

**ABC** (10%)

**DEF** (9%)

**KIL** (8%)

**XYZ** (7%)

Cash Component (Residual)

**Asset Management Company (AMC)**

ETFs are called passive funds because the fund manager does not try to outperform the benchmark index but instead tries to mirror its performance. For example, a NIFTY 50 ETF seeks to generate return which is similar to NIFTY 50 Total return index.

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# 02. Advantages of an ETF

## The Exchange Traded Funds (ETFs) are:

- **Easy to Transact** (Can be bought or sold on exchange)
- **Transparent** (Replicates the portfolio and return of stated index (subject to tracking error)
- **Frugal** (Low cost)

ETFs are an investment medium which combine the features of mutual fund & stock investing. On one hand, investors can buy an ETF to get underlying Index returns at low cost (low expense ratio) and on the other hand they can trade in an ETF like a stock at live NAV, to benefit from intra-day volatility, if desired.

Some of the features of investing through an ETF :

### Liquidity

- Trades on exchange like stocks throughout the day
- Priced close to Live NAV, hence can be bought and sold intra day at current value

### Low Cost

- Lower expense ratio than active equity funds since active fund management is not required
- No Exit Load

### Transparency

- Portfolio is disclosed on a daily basis
- Replicates the return of the underlying Index (subject to tracking error)

### Performance

- NIFTY 50 ETFs have outperformed 71% and 85% of large cap mutual funds in the previous 1 year and 3 year period respectivey (as on Dec 31, 2019)*

*Source: ACE MF. ETF performance is compared against 28 large cap funds Regular plan (Growth). As on Dec 31, 2019. Investors should read the offer document to know in details about the product. Past performance may or may not sustain in future.

# 03. ETF v/s MF

## Difference between an ETF and Mutual Fund

Exchange Traded Funds (ETFs) are a professionally managed investment instrument like Mutual Funds. Both provide access to securities and asset classes depending on the desired risk return objective of the fund. The key differences between ETFs and Active Mutual Funds are mentioned in the table below.

| Parameter | Exchange Traded Fund | Active Mutual Funds |
|---|---|---|
| **Trading** | Listed and traded on exchange just like stocks | Open ended mutual funds are not listed on exchange |
| **Transaction Price** | Can be bought and sold at live Nav (iNAV), hence investor can use intra-day market movement | Open ended mutual funds are bought and sold only at day closing NAV |
| **Returns Objective** | Aims to generate returns which are similar to the benchmark Index | Aims to generate returns based on fund managers skill and view & aims to outperform the benchmark Index |
| **Portfolio** | Replicates the portfolio of the benchmark Index | Portfolio is created based on fund manager view, within the investment objective of the fund |
| **Cost** | Lower cost since active management of the portfolio is not required<br>Average expense ratio of Nifty 50 ETFs is 0.08%*1 | Active management of portfolio etc. leads to higher cost<br>Average expense ratio of large funds is 2.2% (Regular)*2 |
| **Exit Load** | No Exit Load | Can have Exit Load |

*Source: ACE MF. *1 Average of 17 NIFTY 50 ETFs. *2 Average of 28 large cap funds Regular plan (Growth). Behaviour of Plain vanilla ETFs and open ended mutual funds are explained in this note. As on Dec 31, 2019.

# 04. Why ETFs now?

With large cap funds finding it increasingly difficult to outperform benchmark indices like NIFTY 50, ETF provides a low cost investment avenue to take exposure of various segments of the markets including large caps. Through investment in ETFs, investors may create wealth along with comfort of portfolio transparency and tradability like stock.

## Returns

- NIFTY 50 ETFs have outperformed large cap mutual funds significantly in last 1 and 3 year period and NIFTY Next 50 ETFs have outperformed large cap mutual funds significantly in last 5 and 7 year period

| % of MF schemes outperformed by ETFs* | | | | | |
|---|---|---|---|---|---|
| ETF Type | v/s Fund category | 1 year | 3 years | 5 Years | 7 years |
| NIFTY 50 ETF | Large Cap | 71% | 85% | 74% | 41% |
| NIFTY Next 50 ETF | Large Cap | 0% | 22% | 78% | 78% |

*based on 28 large cap funds. Source: ACE MF, as on Dec 31, 2019. For return comparison, average return of all ETFs in a given category is considered. Compared against Regular Plan (Growth). Past performance may or may not sustain in future.

## Outperformance:

- In the previous 3 year, NIFTY 50 ETFs have outperformed large cap MFs by an average of 2.7%

| Outperformance by ETFs (%)* | | | | | |
|---|---|---|---|---|---|
| ETF Type | v/s Fund category | 1 year | 3 years | 5 Years | 7 years |
| NIFTY 50 ETF | Large Cap | 1.5% | 2.7% | 0.8% | -0.3% |
| NIFTY Next 50 ETF | Large Cap | -10.4% | -1.8% | 1.0% | 1.1% |

*based on 28 large cap funds. Source: ACE MF, as on Dec 31, 2019. For return comparison, average return of all ETFs have been compared with the average returns of MFs, in a given category, Compared against Regular Plan (Growth). Past performance may or may not sustain in future.

## Aims to act as wealth creator:

Since 2005, NIFTY 50 has given an average rolling return of 16.3% for an investment period of 5 years and average rolling return of 17.2%, for an investment period of 3 years (Source: ACE MF, as on Dec 31, 2019)

## Seeks low investment cost:

Average expense ratio of large cap funds is 2.2% (Regular Plan: Growth) as compared to the average expense ratio of 0.08% for NIFTY 50 ETFs (As on Dec 31, 2019)

## Transparency:

ETFs are based on public indices and disclose their holdings on a daily basis, enabling investors to know what they are investing into on a regular basis.

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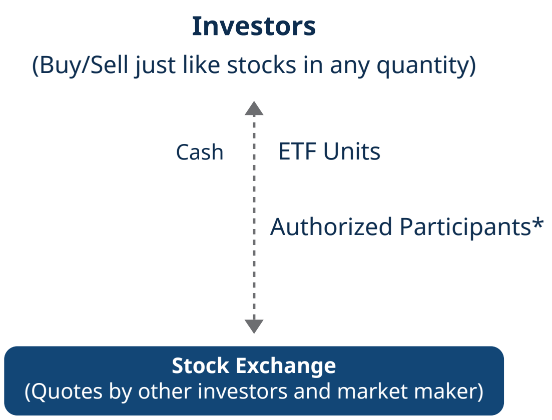
# 05. How to trade in an ETF?

**Transaction on Exchange**




Authorized participants are assigned by the AMC to provide continuous liquidity on the exchange around real time NAV. They provide both buy and sell quotes like Banks in force market.

## Transaction on Exchange

As the name implies, Exchange Traded Funds can be bought and sold on stock exchanges, just like stocks. For example a NIFTY 50 ETF (An open ended scheme replicating/tracking Nifty 50 Index) can be listed and traded on either or both National Stock Exchange (NSE) and Bombay Stock Exchange (BSE).

On the stock exchange, buy and sell trades for ETF units are usually carried out by

- **Existing or new investors**
- **Authorized Participants (AP)** who act as a market maker by providing both buy and sell quotes, with some spread. Since AP provides these quote based on intra-day indicative Net Asset Value (iNAV), the prices of ETF units remain close to their latest NAV throughout the day.

## For example,

Lets say the closing NAV of a NIFTY 50 ETF on Feburary 26, 2019 was 108.50. On the next trading day, if NIFTY 50 index moves up by 1% by 10:30 am, NIFTY 50 ETF will trade around in its iNAV (indicative NAV) on exchange wich will also be higher by 1%, i.e 109.585 at 10:30 am on February 27, 2019.

The investor who wants to buy or sell ETF units from exchange (in multiples of one unit) can go to their brokerage account and trade in ETF units just like stocks.

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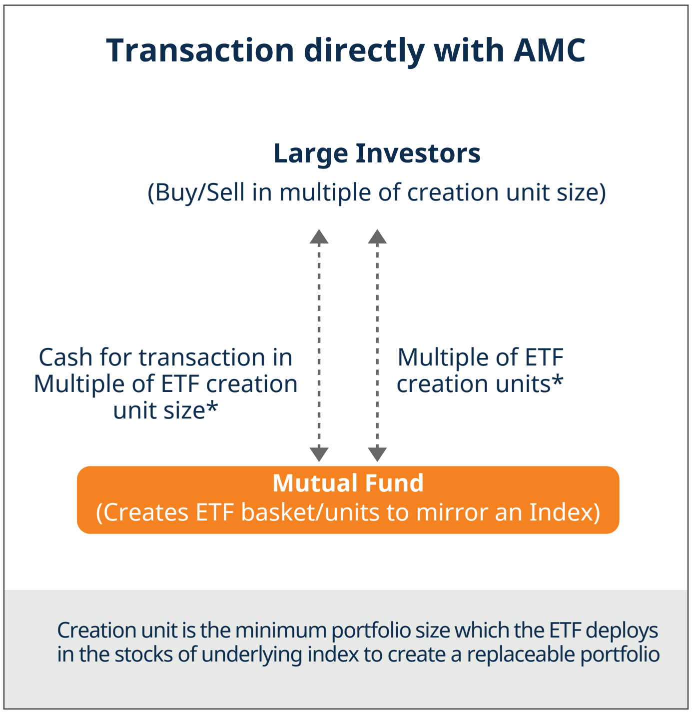


## Transaction directly with AMC or Authorized Participant

Large investors, who want to trade in multiples of creation unit size can also buy or sell ETF units from Authorized Participants (AP) or Asset Management Company (AMC), instead of the stock exchange, if desired.

A creation unit is a portfolio which mirrors the composition of the underlying index and represents "x" amount of ETF units. For example, the creation unit of NIFTY 50 ETF will consist of 50 companies with similar weight as in NIFTY 50 Index and some minor cash component. A creation unit size of a NIFTY 50 ETF which has a NAV of 112 and consists of 50,000 ETF units will be Rs 56 lakh.

## Transaction through AMC:

The investor can approach the AMC, which will provide the latest iNAV of the ETF unit and the current creation unit size. In order to buy, investor will have to transfer the following amount to the AMC.

**(iNAV of ETF Unit x number of ETF units in creation unit) + tax & transaction charges + Cash Buffer**

Upon transfer of this amount, the AMC will implement the trade. The total amount charged will be based on the price at which the trade is executed and will include the transaction charges like STT, demat charge etc. The remaining amount will be returned to the investor and the ETF units will be credited to the investor demat account. The sell order will be executed similarly, where ETF units will be redeemed by the AMC and the amount will be credited to the investor bank account.

## Transaction through Authorized Participant:

The Authorized Participant will provide the following information to the investor,

- **Indicative NAV:** The latest intraday iNAV of the ETF unit.
- **Spread:** The spread over iNAV which may be charged by the AP.
- **Final Execution price:** Indicative NAV +/- Spread as agreed by investor

If agreed, AP will provide the above quotation on the stock exchange. The investor can now execute the trade for the agreed price and amount on the exchange. The list of Authorized Participants of an ETF is mentioned on the respective AMC's website.

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# 06. Glossary

## Authorized Participants (AP):

Authorized participants are essentially ETF liquidity creator on the exchange. They provide supply of ETF units (both buy and sell side) on the exchange and keep the price of ETF units around its iNAV.

## Creation Unit:

A creation unit is a portfolio which mirrors the composition of the underlying index and represents “x” amount of ETF units. These are the smallest block of multiple ETF units that can be bought or sold from the AMC and AP directly.

## Index:

An index is a portfolio of asset like equity stock which represents a segment of the financial market based on a defined methodology. The calculation of the index value comes from the prices of the underlying holdings and its weight. Indices may have constituent weights based on full m-cap, free float m-Cap, equal weighing or factors like volatility etc.

## Indicative net asset Value (iNAV):

iNAV provides an intraday indicative value of an ETF based on the intra day market values of its underlying constituents. It is used as a reference point for ETF trading

## Passive Investment:

Passive investing broadly refers to a buy-and-hold portfolio strategy for long-term investment horizons, with minimal trading in the market. Index investing is perhaps the most common form of passive investing, whereby investors seek to replicate and hold a market index through investments in ETF or Index Fund.