Financial Services Sector - It's not just Banks

Financial Services

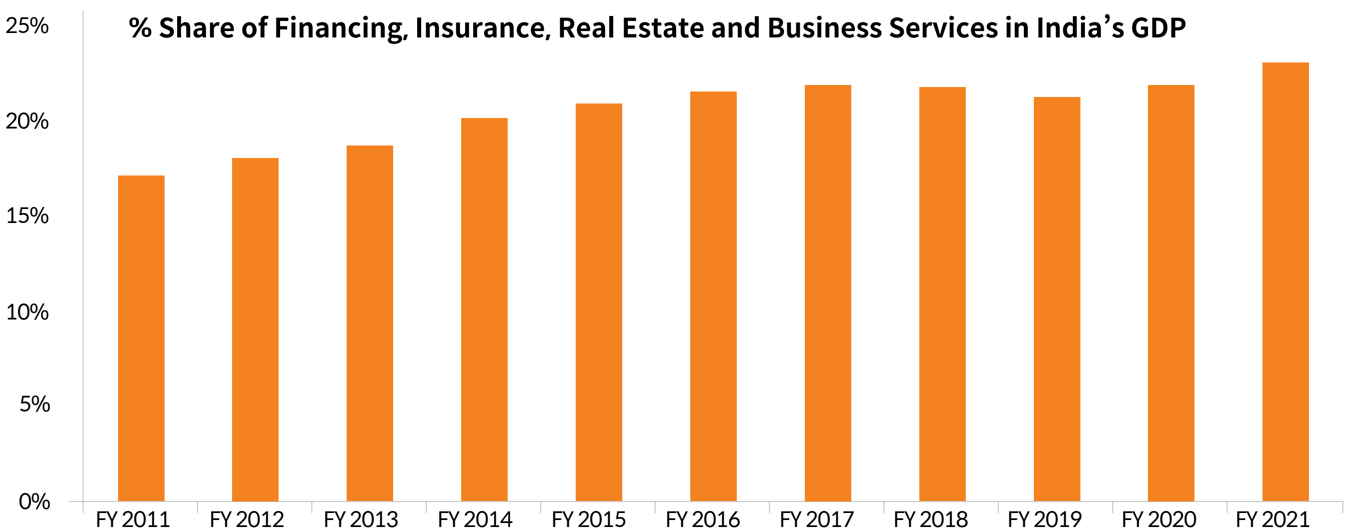
Financial Services is one of the most important sectors of an economy. Financial Services sector comprises of both Banks and Non-Banking Lending Institutions; Insurance and Asset Management Companies are also part of Financial Services Sector. A strong and well regulated Financial Services Sector can be critical for the growth of an economy.

Financial Services in India

The Indian banking system consists of 12 Public Sector Banks, 22 Private Sector Banks, 46 Foreign Banks, 56 Regional Rural Banks, 1485 Urban Cooperative Banks and 96,000 Rural Cooperative Banks in addition to co-operative credit institutions (source: RBI, data as on: 31st March 2021). Most Investors associate Financial Services Sector with Banks. However, the ambit of Financial Services Sector is broader. Apart from Banks, we have Non-Banking Lending Institutions like Term Lending, Housing Finance, Commercial Vehicle Finance, Leasing and Hire Purchase Companies, etc.

The asset management industry in India has been growing at a Compounded Annual Growth Rate (CAGR) of 17.5% over the last 10 years (as on 30th June 2021, Source: AMFI). The total Assets Under Management (AUM) of the Mutual Fund industry Rs. 33,66,876,195 Crores as on 30th June 2021 (source: AMFI). The life and general insurance industry has also registered impressive growth. Premiums collected by life insurance companies have grown at a CAGR of 8% over the last 10 years (as on 31st March 2020 Source: IRDAI). The total premium of LIC and private sector life insurance companies in FY 2019-20 stood at Rs 5,72,910 Crores (Source: IRDAI annual report, FY 2019-20).

Financial services sector in India has been growing at a rate faster than the Gross Domestic Product (GDP) growth rate of India. As per Reserve Bank of India (RBI), the share of Financing, Insurance, Real Estate and Business Services in India's GDP has been growing steadily over the last several years from 17.2% in FY 2010-11 to 23.2% in FY 2020-21.



Source: Reserve Bank of India Annual Reports (from FY 2010-11 to FY 2020-21)

Government reforms

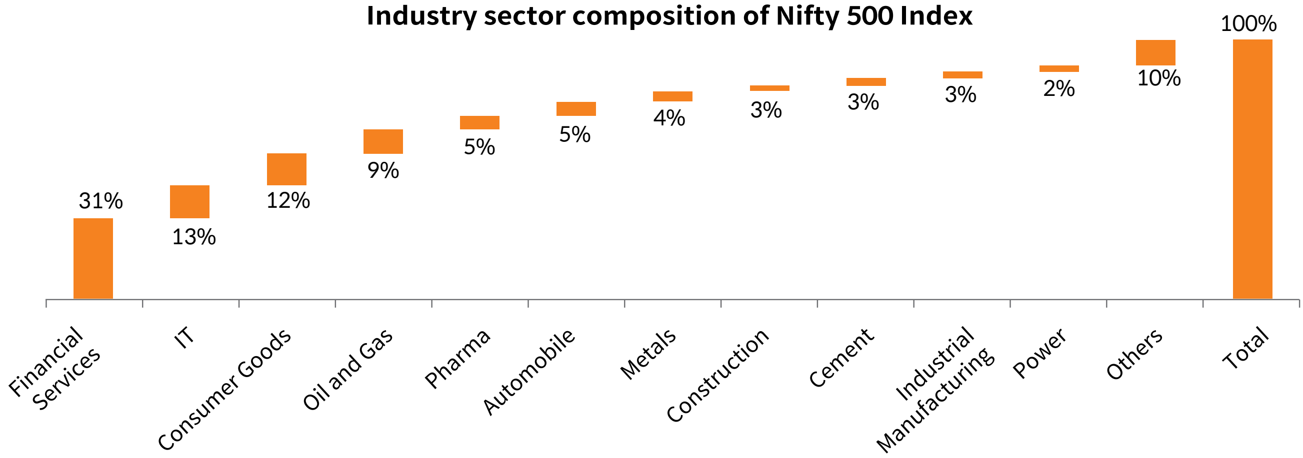
The Government has taken a number of steps to reform and strengthen the banking sector. The Pradhan Mantri Jan Dhan Yojana aimed at providing financial inclusion to all Indians, has brought nearly 43 crore Indians under the banking system (source: Ministry of Finance, data as on 30th June 2021).

The Government has also enacted a number of reforms for public sector banks including mergers, recapitalization, recognition of Non Performing Assets (NPAs) and recoveries. In this year's Union Budget, the Government increased the Foreign Direct Investments (FDI) limit in the insurance sector from 49% to 74%. The Government has also made a major thrust for digitization of payments through the Jan Dhan, Aadhaar and Mobile (JAM) trinity. The Banking and Financial Services Sector is expected to play a key role in the revival of economic growth in the post COVID scenario.

Importance of financial services in equity market

The share of Banking & Financial Services in the market capitalization of Indian equities has been going up steadily over the last decade or so and it is now the largest sector in both the Nifty 50 Index and also the broader market (Nifty 500 Index).

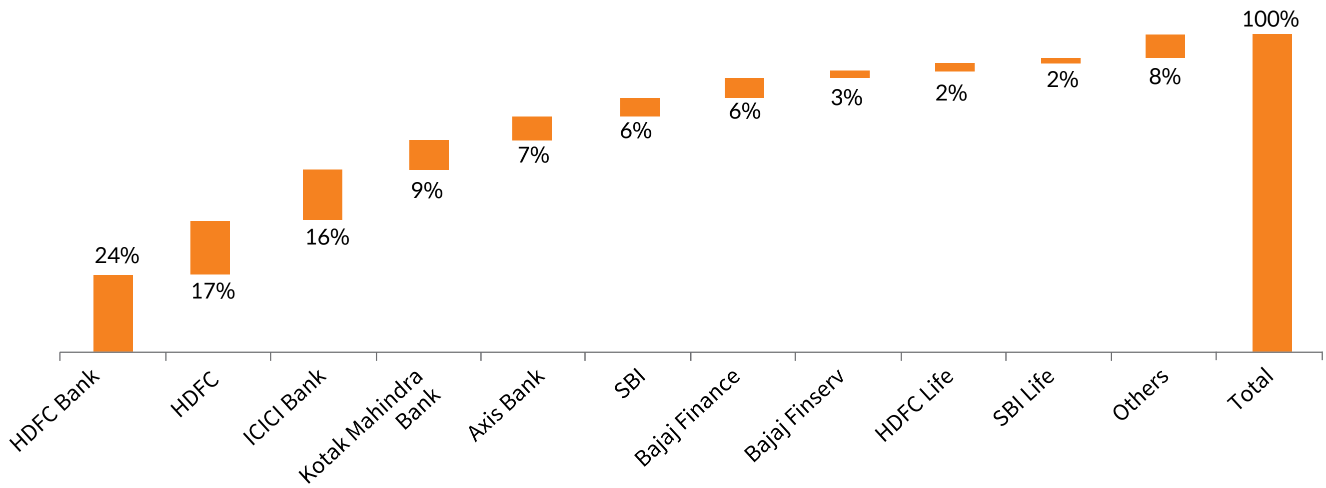
Industry sector composition of Nifty 500 Index



Source: National Stock Exchange (as on 30th June 2021). Sector classification is as per AMFI

Nifty Financial Services Index

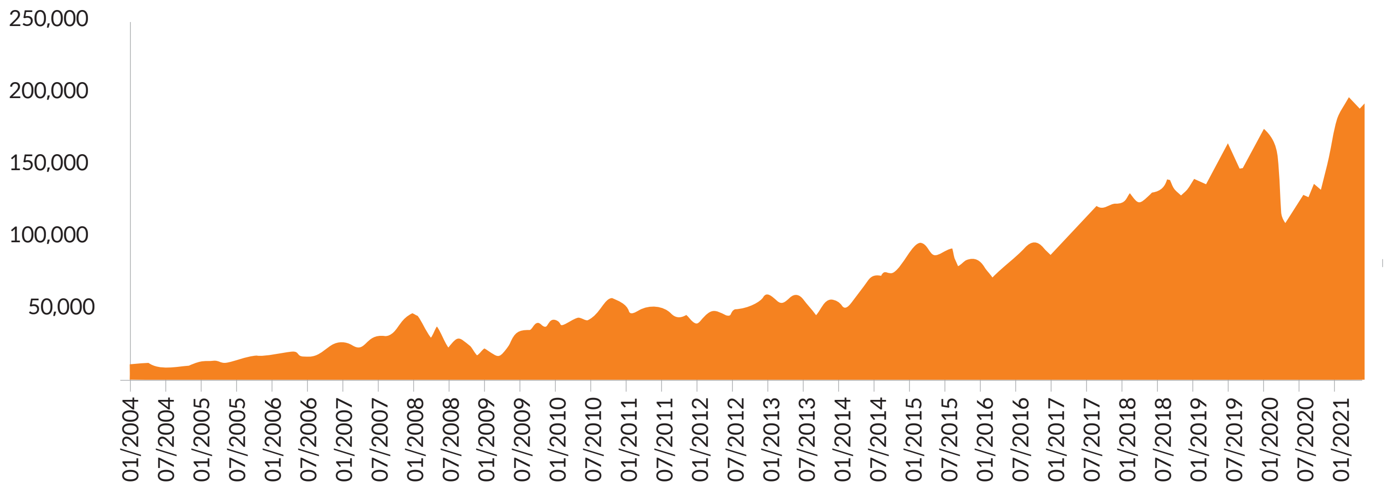
Nifty Financial Services Index which comprises of the 20 largest financial services companies by free float market cap in the National Stock Exchange (NSE) includes banks, financial institutions, housing finance, insurance companies and other financial services companies. NIFTY Financial Services Index is computed using free float market capitalization method, wherein the level of the index reflects the total free float market value of all the stocks in the index relative to particular base market capitalization value. The chart below shows the weight of top 10 companies in Nifty Financial Services Index.



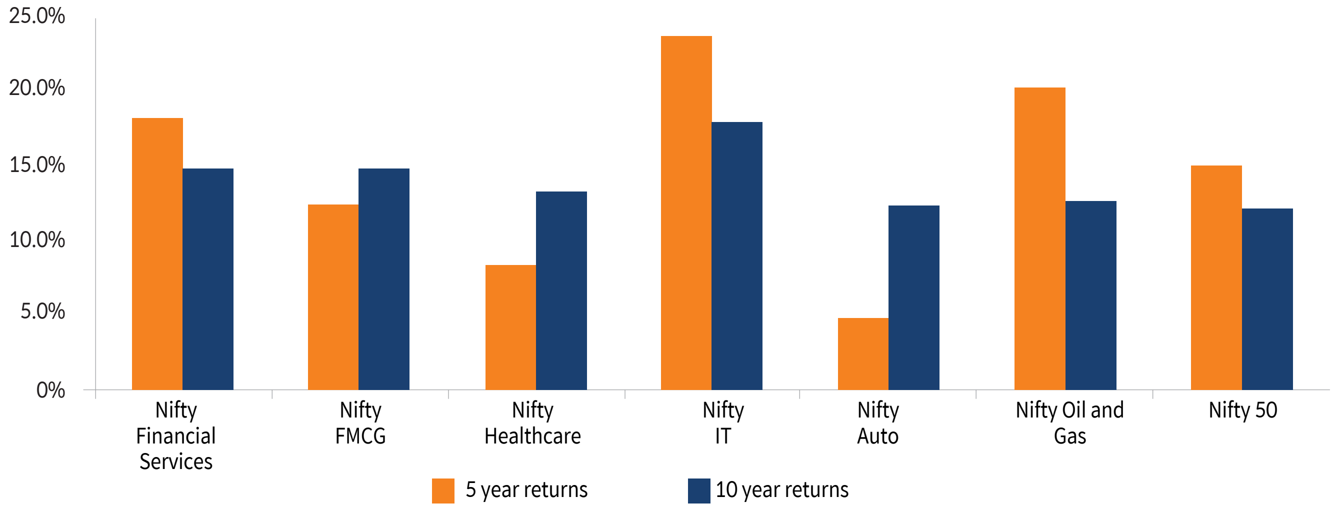
One of the best performing sectors

The chart below shows the 5 and 10 year returns of different sectoral indices versus Nifty 50 Index (as on 30th June 2021). You can see that Nifty Financial Services Total Return Index (TRI) has not only outperformed Nifty 50 TRI but it has been one of the best performing sectors in the market over longer investment tenures.

Growth of Rs 10,000 investment in Nifty Financial Services TRI since inception (CAGR 18.7%)



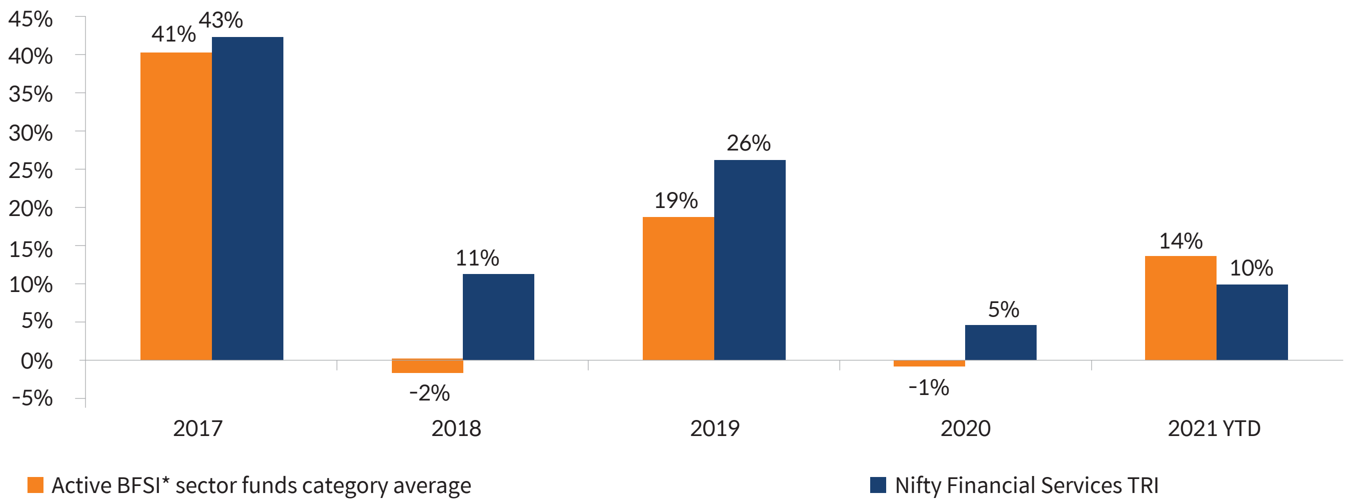
Source: National Stock Exchange, Advisorkhoj Research (Period: 1st January 2004 to 30th June 2021). Disclaimer: Past performance may or may not be sustained in the future



Source: National Stock Exchange, Advisorkhoj Research (Period: 1st July 2011 to 30th June 2021). Note: All indices are total returns indices (TRIs). Returns are in CAGR. Disclaimer: Past performance may or may not be sustained in the future

Passive investing in financial services

Apart from diversified equity funds, which have financial services in their portfolios, there are sectoral funds which invest only in financial services. However, most of these funds have failed to beat Nifty Financial Services TRI (see the chart below). In 3 out of the last 5 years, even most of the top quartile funds in the category were unable to beat the Nifty Financial Services TRI. Therefore, a passive exposure to this sector through ETFs or Index Funds may make sense.



Source: Advisorkhoj Research (as on 9th July 2021). Note: All indices are total returns indices (TRIs). Returns are in CAGR. Disclaimer: Past performance may or may not be sustained in the future.
*Banking, Finance Services and Insurance (BFSI)

Benefits of passive investing

- **No unsystematic risks:** Fund managers of active funds are overweight/underweight on some stocks relative to the index with the aim of creating alphas. This gives rise to unsystematic risks. ETFs and index funds aim to replicate the performance of the index. There is no unsystematic risk.
- **Rule based Portfolio construction:** Rule based selection and weighing ensures that indices are faithful representative of the intended objective with scheduled rebalancing of stocks ensuring inclusion of more relevant stock and exclusion of stock which doesn't satisfy or capture the objective anymore
- **Lower costs:** Total Expense Ratios (TERs) of passive funds are much less than active funds. Costs are deducted in the NAVs of Mutual Fund Schemes. Therefore, a scheme with the lower costs will have higher returns for the same performance of under lying portfolio.

Conclusion

Though diversified equity funds should form the core of your investment portfolio, you may allocate a portion of your investments to sectoral funds to boost your portfolio returns or tactically take advantage of market opportunities. Financial Services funds make sense both from a long term viewpoint (outperformed Nifty over the 10 years) as well as in the current situation. As our economy gets back on the path of growth after the COVID shock, Banking and Financial ServicesSector will play a major role. You should have high to very high risk appetites and long investment tenures (at least 5 years). You should consult with your financial advisor if required .