Aim to get more out of ETFs with Tactical Asset Allocations and smart beta strategies

An Investor Education Initiative
MIRAE ASSET
Mutual Fund
by Mirae Asset Knowledge Academy

Passive investments via Exchange Traded Funds (ETFs) have gained traction in recent years after being adopted by the Employee Provident Fund Organisation (EPFO) for its equity investments. Assets Under Management (AUM) soared 55% to Rs 2.11 lakh crore in July 2020 from Rs 1.36 lakh crore in April 2019, when the Association of Mutual Funds in India (AMFI) began publishing data in the new format.

Globally, ETFs comprise a considerable share of the regulated mutual fund industry, at 11%, and an even higher share of the US fund market, at 19%. Also, the adoption of ETFs in developed economies has shifted from basic beta exposure to advance strategic asset planning (see chart below).

In this article, we analyse two applications - Tactical Asset Allocation (TAA) and smart beta strategies - for investors in India to consider getting more out of their investments.

Top 10 applications of ETFs

S.No	Application For ETFs	2018	Description
1	Tactical adjustment	72%	Use ETFs to adjust asset allocation based on market and economic environment.
2	Core allocation	68%	Create a strong core portfolio in line with the investor's strategic asset allocation plan by investing in ETFs.
3	Rebalancing	60%	Use ETFs to rebalance the portfolio periodically and align the investor's portfolio to its financial path.
4	Portfolio completion	57%	Fill in gaps, if any, in the overall strategic portfolio by investing in ETFs.
5	International diversification	56%	Use ETFs as a medium to diversify investor's portfolio into international markets at low cost.
6	Liquidity management	54%	Considering the ease of liquidity of ETFs, use a portion of ETF investments to meet planned and unplanned liquidity needs of the investor.
7	Transition management	44%	Use ETFs as a medium to park money for short term before the selection of right investment strategy and avenue for the monies.
8	Risk management	42%	With the multitude of options available under ETFs, they provide an able avenue to hedge risks in portfolio.
9	Interim beta	37%	Similar to transition management, ETFs can be used by investors to park money for short term, whenever they look at modifying their long term strategies.
10	Cash equitization	37%	Use ETFs to park their cash surplus and reduce cash drag on the overall portfolio returns.

Source: Greenwich Associates' report on ETFs: US Institution' New Tool of Choice for Portfolio Construction (Q1 2018).

TAA

In Strategic Asset Allocation (SAA), Target Asset Allocation is fixed and goal-oriented whereas in TAA, the asset mix is changed in response to the market and economic environment. An investor actively tracks the market and overall economic scenario and then stays neutral-weighted, over-weighted, or under-weighted with respect to a particular asset (or more than one asset). For instance, allocation to equity is adjusted as per valuation wherein, if valuations are low, portfolio equity allocation is increased and debt reduced. When valuations are high, equity allocation is reduced and debt allocation increased.

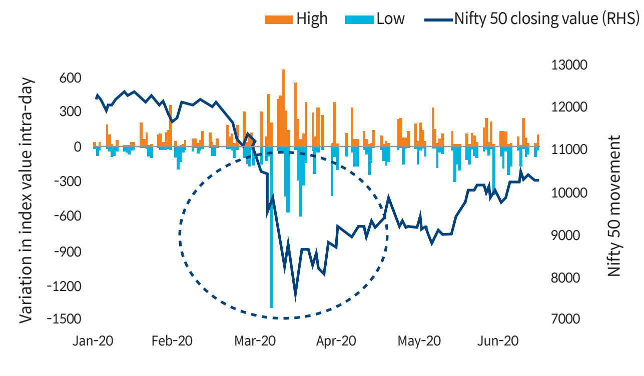
TAA has two variants - systematic and discretionary. A systematic TAA makes use of quantitative indicators to benefit from the temporary market anomalies/imbalances among different asset classes. Discretionary TAA uses a more qualitative approach which is informative but difficult to measure. It involves analysing the political, economic and financial market situation and then taking a call on the asset mix.

A TAA strategy can be a value addition to an SAA strategy by increasing allocation to those assets expected to outperform and reducing allocation to those likely to underperform. It enable investors to better handle market volatility, mitigating downside risks and enhancing returns by benefiting from an advantageous market scenario.

Case study – Benefits of TAA

Investors can buy and sell ETFs intra-day or at any time during market hours, unlike traditional equity mutual funds that get the closing Net Asset value (NAV) for investment. The TAA strategy of investment in ETFs provides an ideal opportunity to invest, based on market volatility. For instance, as seen from the chart below, investments in ETFs during volatile periods, correlating to market lows, allows investors to buy more units, thus giving investors a better deal on their investments over the long term.

Nifty closing versus its intra-day high and low closing value



Notes: Data from January 1 to June 30, 2020.
High represents the variation in absolute value of the high point of the index intraday versus that day's closing value.
Low represents the variation in absolute value of the low point of the index intraday versus that day's closing value.
Source: National Stock Exchange of India

Let's use an example to bring to the fore the benefits of investing in ETFs during periods of market volatility, as in the six months ended June 30, 2020.

Two investors, Sameer and Aamir both invest Rs 1,000 daily in the market (Nifty 50). While Sameer invests at the low point of the index every day, Aamir invests at the closing value of the index. The end results of their investments are detailed in the table below.

Particulars	Samir	Aamir
Daily investment value	Rs 1,000	Rs 1,000
Investment strategy	Investing at market lows during the day	Investing in market closing value
Total amount invested	Rs 1.23 lakh	Rs 1.23 lakh
Value of investment	Rs 1.26 lakh	Rs 1.23 lakh
Investment returns (XIRR)	9.4%	4.2%

Source : CRISIL Research.

Clearly, just by investing efficiently during the market lows, Sameer was able to generate 9.4% returns in the period, compared with 4.2% by Aamir. While investing at market lows is not possible every day for investors, ETFs provide an opportunity to tactically invest in the market during market lows or during a low-cost buying opportunity.

Additionally, since ETF investments are transparent and known to investors in terms of portfolio exposure, it is easier for investors to take tactical calls on overall index valuation and placement compared with the overall market, unlike an equity mutual fund whose exact portfolio universe might not replicate its benchmark.

Beta strategies options available across a wide palette

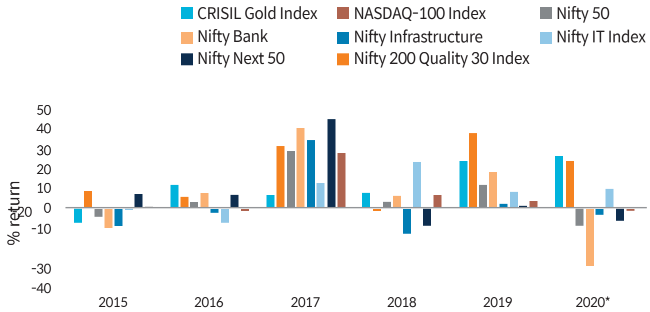
ETFs also provide an opportunity for investors to use the beta strategies avenue in long-term investment planning. ETFs in India have grown in terms of the options available across pure equity, gold, debt, overseas as well as smart beta indices, thus providing a wide palette of investments.

Diversified ETF offerings in India

Index ETFs	Sectoral ETFs	Gold ETFs
Tracks broader market indices like Nifty 50, S&P BSE Sensex, Nifty 100 or Nifty Next 50.	Exposure to stocks belonging to a particular sector such as banking (private and PSU banks), consumption, infrastructure.	Track the domestic physical gold price and invest in gold bullion.
Debt ETFs	**Country specific ETFs**	**Other ETFs**
Invest money in the bonds in issued by public sector companies It can also be ETFs investing in Tri Party REPO, Repo in Government Securities, Reverse Repos and similar other overnight instruments investing in long-term gilts.	Invest in same proportion in the securities of the global index like Hang Seng, Nasdaq, etc.	ETFs tracking Nifty 100 low volatiliy 30 index, 12 state-owned companies that are a part of the Nifty CPSE index.

By identifying efficient market segments and strategies, investors can opt for compliment allocations to their overall investment planning. For example, the chart below shows the returns from select market indices over the last six years. While there have been different outperformers during different years, gold, represented by CRISIL Gold index, for instance, offered superior returns in the latest year even as the broad market represented by the Nifty 50 languished. In 2018, the IT sector, represented by the Nifty IT index, offered superior returns, while even in the current year, it offered decent returns despite the market volatility.

Variation in efficient market segments



*till July 21

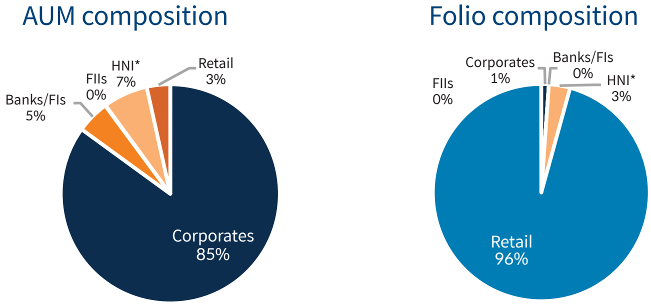
Source – NSE, CRISIL Research.

Additionally, the investments across various efficient market segments also work well with the fundamental rule of diversification for successful financial planning. Beta strategies in ETFs aid diversification while also providing investors the opportunity to invest in efficient market segments.

Current investor profile of ETFs

After the advent of EPFO, the ETF industry has become highly skewed towards institutional investors/corporates accounting for 85% of category assets, while in terms of folios (investor accounts), retail investors have the largest count with 96%+ share as of March 2020.

Composition of ETFs in India

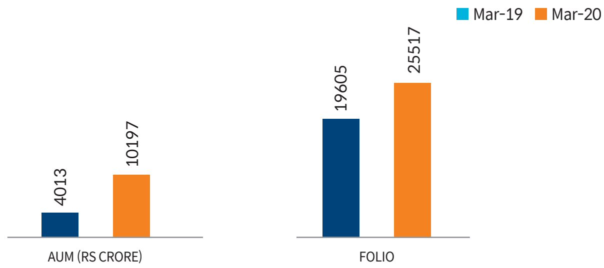


Source: AMFI, data as of March 2020

*Defined as individuals investing Rs 2 lakh and above

Interestingly, in the last one year, the high networth (HNI) investor segment, that used to languish at third position in terms of assets and folios, has picked up pace to capture second position in both aspects. This might indicate those investors, with some help in financial planning and who are looking at alternative strategies, are looking at ETFs as an increasingly attractive investment opportunity.

HNI segment has picked up the ETF trend



Summing up

The changing market scenario compels investors to look beyond conventional avenues for their financial planning. ETFs, with TAA and beta strategies, offer investors an attractive investment opportunity. However, investors should be well advised to make a holistic analysis of individual parameters such as risk tolerance, investment goals and time horizon before embarking on this phase of their investment journey.