Monthly Musings

June 2022

Understanding index investing

HDFC MUTUAL FUND
BHAROSA APNO KA

Index

Message from Navneet

'On what is expected to be a wet rainy January day, thunderstorms and heavy rains are expected to lash the city tomorrow'. If you would have come across this newspaper headline a decade or two ago in January, in all likelihood, you would have thought that it was a blunder by the Meteorological department or a goof-up by the newspaper. Not anymore though. This year most parts of India witnessed unseasonal rainfall in January, with Delhi receiving highest January rainfall since 1902. If you have been following the weather news across the world, you would have noticed that such erratic weather patterns and extreme weather conditions have become far too recurring and worrying in nature.

Naturally, this has turned the spotlight on global warming /environmental issues. In light of this, it's indeed the need of the hour that all stakeholders take their responsibility seriously in this regard. On our part, last year, on the occasion of 'World Environment Day', we had initiated the #NurtureNature campaign with the promise of planting a tree for every SIP registered digitally during the campaign period. Seeing the positive response to the inaugural edition, we came back with the second edition of this campaign in June 2022 (1st June 2022 to 10th June 2022) and received an overwhelming response to our campaign. We also conducted plantation drives with our distribution partners across the country. We hope that through such initiatives, we can continue to play an important role in 'nurturing nature'

Speaking of nurturing, every child, during its formative years, needs affection and attention, from both parents to develop to full potential. While the bond between mother and child is priceless, the one between a father and child is equally unique. A father is often the pillar of strength and source of inspiration for kids growing up. As an ode to the unique relationship between father and child, this Father's Day (19th June 2022), we conducted outdoor events for our MFDs and their kids at various locations across the country. We hope this initiative gave the kids and their proud dads a day to remember for a long time.

Long time, it's certainly been, since our first passive offering was launched on 17th July 2002. On the occasion of 2 of our index solutions viz. HDFC Index Fund – NIFTY 50 Plan and HDFC Index Fund – S&P BSE SENSEX Plan turning 20, we dedicate this issue of Monthly Musings to Passive Investing. Hope you find it informative and interesting. Here's to being #TrustedFor20 and many more to come!!!

Happy reading!!

For product labelling and riskometer please refer to page 17

HDFC MUTUAL FUND
BHAROSA APNO KA

HDFC MF INDEX SOLUTIONS

Trusted for 20

We Celebrate

HDFC Index Fund - NIFTY 50 Plan &
HDFC Index Fund - S&P BSE SENSEX Plan

completing 20 years
on 17th July 2022.

For product labelling and riskometer please refer to page 17

Cover Story

Index Solutions - Global trend gaining traction in India

Index solutions, also known as passive funds, are financial products which track an underlying benchmark / index. In India, index solutions come in two main formats – Exchange Traded Funds (ETFs) and Index Funds. ETFs are mutual funds that are traded like a stock on an exchange. Like a mutual fund, they allow investors to pool their money and get access to a portfolio of securities through a single product. And like a stock, they can be traded through the day during market hours on an exchange. Investors need a demat account to trade in ETFs.

Index Funds are a type of mutual fund which track an underlying index. Unlike ETFs, such funds do not trade on a real-time basis. Investors can invest or redeem their money at the End of Day NAV of the fund. Investors do not need a demat account to invest in index funds.

Index solutions* offer broad exposure to a wide variety of asset classes.
Some of these include-

- **Equity**
  - Marketcap based / Broad – Eg. Nifty 50, Nifty 100
  - Sectoral or Thematic – Eg. Nifty IT, Nifty Private Bank
  - Smart Beta – Eg. Nifty200 Momentum 30
  - ESG – Nifty100 ESG
- **Debt / Fixed Income –Indices based on Fixed income instruments including Government securities, SDLs, T-bills, corporate bonds etc.**
- **Commodities – Gold, silver etc.**
- **International Equity – Eg. MSCI World Index**

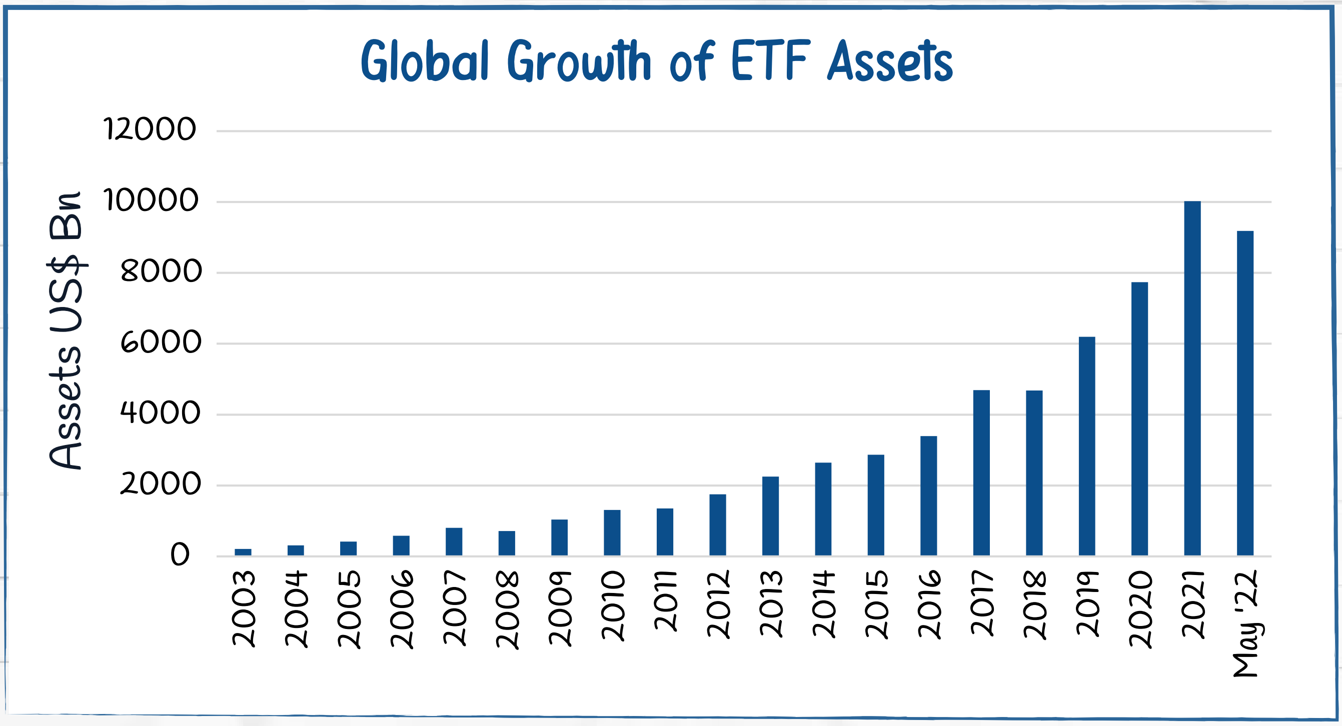
* Index Solutions referred here include passively managed fund of funds and commodity(ies) based schemes.

Benefits of Index Solutions

1. Simple to understand
2. Transparent – constituents and weights are disclosed periodically by the index provider. ETFs disclose their constituents daily.
3. Low-Cost products

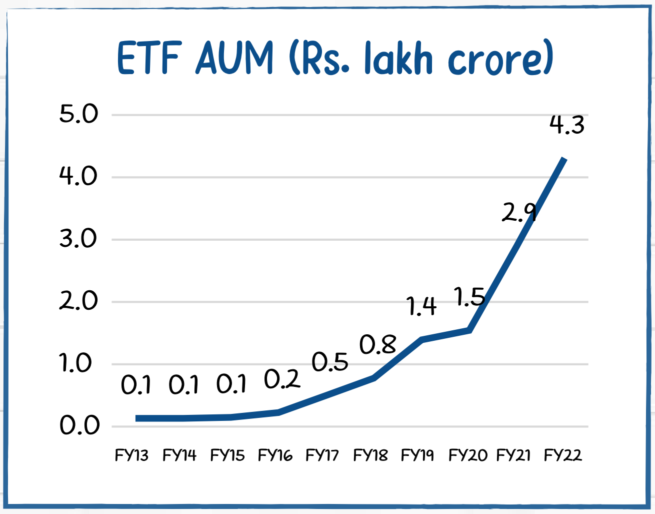
Growth of ETFs - India and international

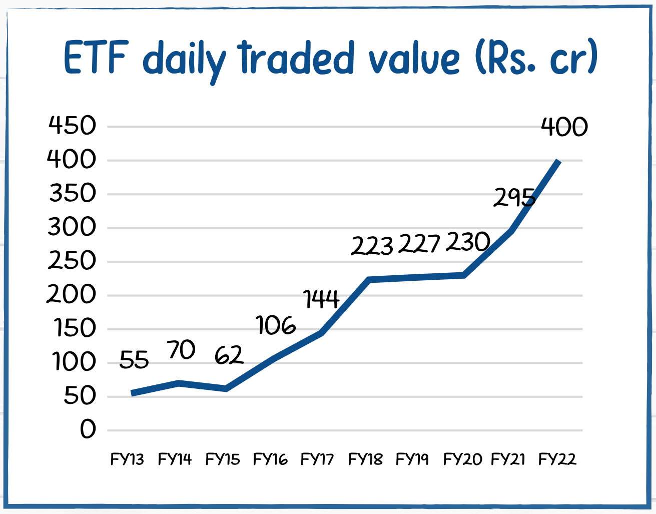
Index solutions have become increasingly popular with investors in recent times. This is visible in the growth of both international and domestic index solutions as explained below. Globally, growing popularity for Exchange traded Funds (ETFs) has resulted in exponential growth in AUMs in the past two decades. Internationally, ETFs crossed a total AUM of US$10trn in 2021, up from US$1.35trn in 2011.



Source: ETFGI. Data as of May 2022.

In terms of AUM, Equity ETFs are by far the biggest category in the global ETF pie. However, if recent trends are to be considered, other categories such as Debt, Commodity, Hybrid and Alternative strategies have also been making their mark. We observe a similar trend in India too, with ETFs now exceeding Rs. 4 trillion in AUM (accounting for more than 10% of total mutual fund AUM). While it is in line with global trends, some India specific factors are also at play. Large public institutions have been using ETFs as a key portion of their portfolios to invest in Equities since 2015. Similarly, investors have been using sectoral ETFs to gain easy exposure to specific sectors instead of securities. Debt ETFs have also grown in popularity with institutions.

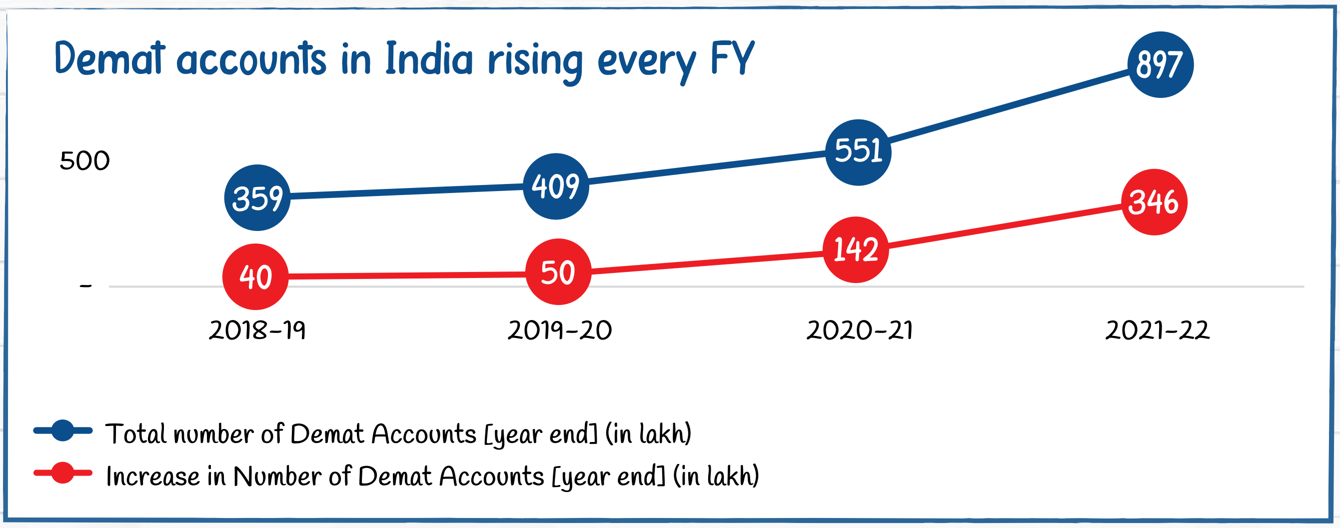




Note: Above includes all ETFs listed in India as on 31 Mar 2022
Source: Bloomberg, AMFI

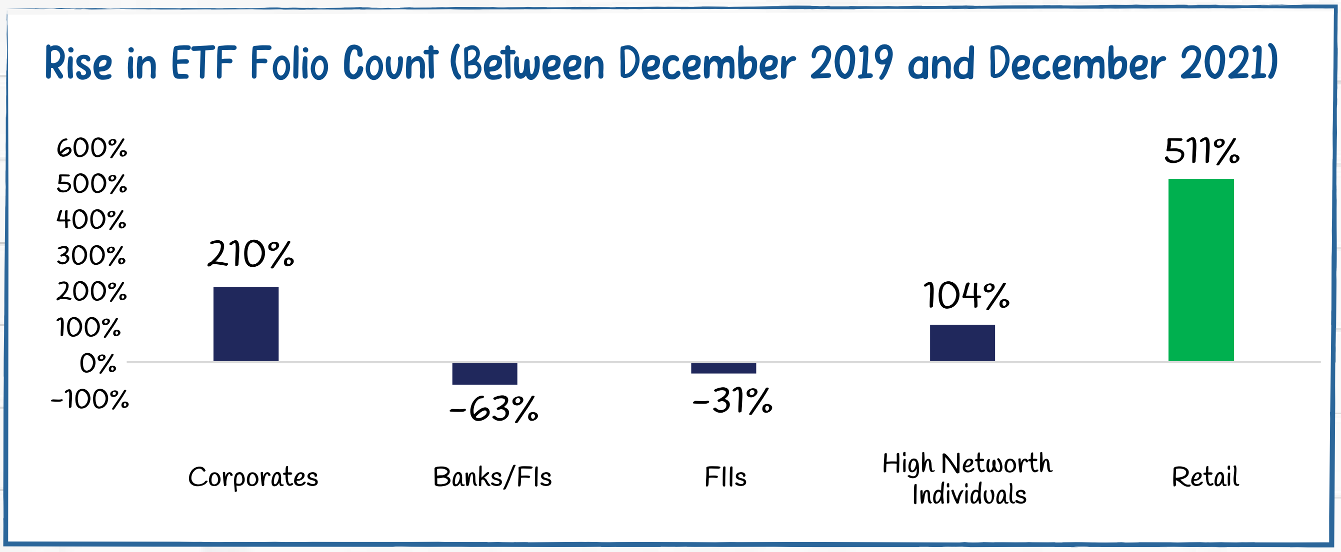
Rising retail participation in India

The rising participation of the retail investor across ETFs has been a noteworthy trend. In the past few years, retail investors have benefitted from the rapid financial democratization of the Indian investment landscape. Democratization of investments refers to the improvement in the ease of access for investors to deploy their capital among a wide range of financial products. One outcome of this trend has been a significant growth in the number of demat accounts. Since FY19, demat accounts have more than doubled to 8.6 crores* (considering both NSDL and CDSL Depository Participants). The last 2 financial years – FY21 and FY22 have seen ~5 crore demat accounts being opened, signaling the rising interest of retail investors to invest in equity and equity related products.



Source: CDSL and NSDL, *As on March 31, 2022

This rapid rise in the opening of new demat accounts has helped facilitate a tremendous increase in the number of ETF folios, especially over the last 2 years. As is evident from the chart below, there has been a 6-fold growth in number of retail folios between December 2019 and December 2021 – from 19 lakh folios at end of 2019 to 1.15 crore folios at the end of 2021. This exponential increase indicates the degree of traction ETFs are getting among investors.



Source: AMFI India

We expect ETF adoption to continue to increase. Reasons for this include continued rapid rise in demat accounts in India, increasing awareness of financial products apart from traditional bank deposits, higher ETF trading volumes driving impact costs lower and new product launches from AMCs in the ETF space.

Conclusion

- Index solutions aim to track an index and thus generate returns as close to the index as possible.
- Index solutions come in two main forms – ETFs and Index Funds.
- They allow investors to easily get broad exposure to various asset classes including equities, debt, commodities and international equities.
- Their main benefits include simplicity, transparency and low-cost.
- ETFs are extremely popular globally with total AUM close to $10trn.
- Mirroring the global trend, the popularity of ETFs has been rising rapidly in India as well.
- Apart from large institutional flows into ETFs, a boom in demat account openings by retail investors over the last 2 years has helped lead to a surge in the number of ETF folios as well.
- Looking ahead, index solutions are expected to gain even more importance in building a diversified portfolio for investors.

Jargon Dejargonised

Market Maker

Investors interested in investing in ETFs would have come across the term Market Maker. So what are Market Makers and why are they so crucial to the ETF ecosystem?

Market makers (MMs) are financial firms which provide liquidity to ETFs by standing ready to buy and sell ETF units from investors. They allow investors to build or exit their ETF positions easily and also help to keep the ETF price in line with its fair value ie. Net Asset Value (NAV)#. The combined benefit is that investors can transact in ETFs close to NAV in a low-cost manner.

How MMs play a role in providing liquidity to a security?

Liquidity refers to the ease with which an investor can convert their asset to cash close to fair value and vice versa. Bluechip stocks, G-Secs etc. have high liquidity since it is easy for a seller to find a buyer at a given time. However, for some securities, finding buyers and sellers willing to trade with each other in large quantities at all times can be difficult. This is where the market maker steps in. MMs stand ready to both buy and sell securities from investors in the desired quantity. In this way, MMs increase liquidity of the ETF, with sellers having the comfort they will be able to exit their holdings easily when they want. Buyers benefit too, since they can quickly build a large position in the ETF.

MMs role in price discovery

In addition to boosting liquidity for an ETF, MMs also help in an ETF to trade at a price closer to its fair value ie. NAV. Let's recall the market price of the ETF is determined by the immediate demand and supply conditions for the ETF in the market. These short-term fluctuations can drive the price of the ETF temporarily higher or lower than the NAV, which is known as trading at a premium and discount respectively. MMs can lessen these fluctuations and cause the ETF to trade closer to the NAV. This is because they have the ability to create or redeem ETF units in large quantities with the AMC. For example, suppose the ETF is trading at a large premium ie. higher than NAV. This is an unfavourable scenario for a potential buyer of the ETF, as they will end up buying the ETF for more than fair value. To bring the price closer to NAV, the MM may buy ETF units from the AMC^, and sell these units on the market.

SEBI's May '22 circular, commonly known as 'Circular on Development of Passive Funds', has provisions relating to MMs in the ETF ecosystem. SEBI has increased the minimum ticket size for which investors can transact directly with the AMC to Rs. 25 crore.
As a result, several investors who were transacting directly with the AMC when the previous lower minimum amount was applicable, will now transact on the exchange.
This will bring additional trading to the exchange and benefit investors through better liquidity and higher trading volumes, leading to even lower costs for investors.

* Market makers can provide liquidity to a wide range of securities beyond ETFs eg. equities, bonds etc. # ETF's NAV is the value of all the securities held by the ETF - such as shares and cash, minus any liabilities such as Total Expense Ratio (TER), and divided by the number of units outstanding
^ this is known as primary market subscription

Smart Choices

Active and Passive Funds

We keep hearing the terms 'active' and 'passive', when it comes to mutual fund investing. Herein, we discuss the conceptual basics of the two styles and delve into the key differences between them

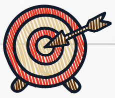
Outperform vs tracking the underlying benchmark

Actives	Passives
Active funds aim to outperform their respective benchmark mainly through superior stock selection	Passive funds aim to simply track the returns of their desired benchmark as closely as possible
Active managers often employ large teams of analysts to assist in their stock selection calls	Do not take 'active' calls on stock and sector selection.
Fund manager takes an overweight position as compared to benchmark on stocks which he/she believes are 'attractive'	Seeks to buy the same stocks in the same weights as the underlying index
Evaluated based on their outperformance over their benchmark	Evaluated on how closely they track their underlying benchmark
HDFC Flexi Cap Fund is an example of an active fund	**HDFC NIFTY 50 ETF** is an example of a passive fund

For product labelling and riskometer please refer to page 17

Active Vs Passive – How Portfolio Changes Occur?

Active and passive funds, both adjust to changing leadership trends across the economy and markets over time.



Active funds aim to be invested in stocks where the fund manager has highest conviction and which are available at attractive valuations. The fund manager adjusts the portfolio on an ongoing basis as newer opportunities emerge.

The portfolio of passive funds also changes, but gradually, as the underlying index changes periodically. These changes happen usually twice a year with a few companies being replaced to reflect changing market dynamics. This is known as rebalancing.

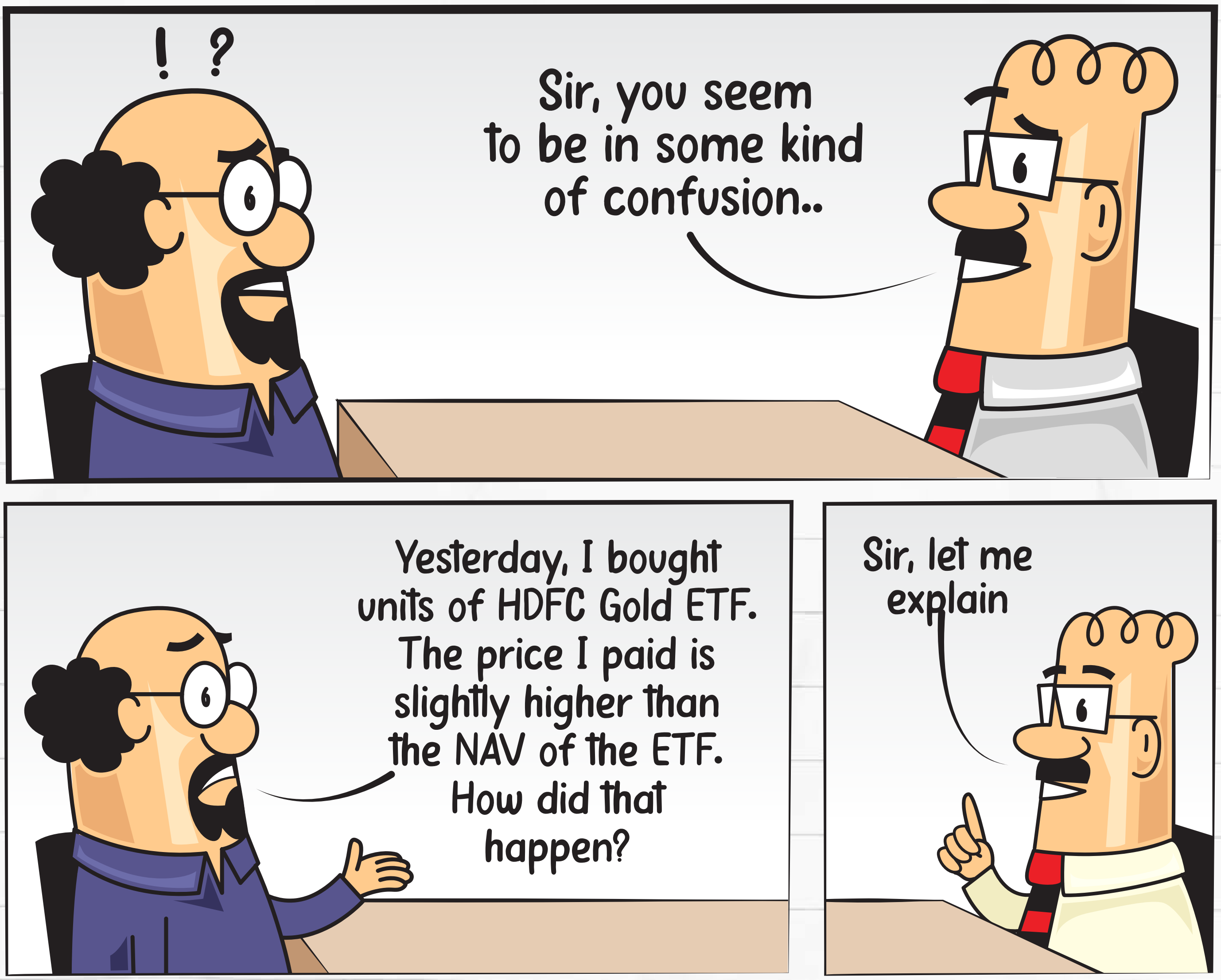
For example, the weight of the Retail Bank & Financials sector in NIFTY 50 index has increased from 13.6% from the end of May 2012 to 22% at the end of May 2022. This reflects the growing importance of retail banks in the Indian economy and this trend has been captured by rising sector weight of Retail Banks within the index.

Companies that grow over a period of time, generally see their market cap (size) increase and thus eventually enter the most widely tracked indices. This in turn leads to passive funds purchasing and holding such companies and participating in future share price appreciation.

Meanwhile companies past their prime may tend to experience falling market cap (size), and these are gradually removed from the index and hence sold from passive funds as well. Therefore, a passive fund portfolio also stays 'fresh', reflecting the growth and decline of companies and sectors as the underlying economy evolves and the index adjusts.

Investors can blend active and passive styles for their portfolio.
Investors can invest in active funds with the aim of outperforming the market. Additionally, they can also invest in passive funds to track various indices. A diversified approach across active and passive funds may be considered by investors. Passive funds aid the investor to earn the market return (subject to expenses and tracking error) on a certain portion of their funds, while investing in active funds provides scope for outperforming the market and boosting overall portfolio returns.

Tete-a-tete



NAV and Price of an ETF

It is normal for an ETF to trade in the secondary market at a price which is higher (a premium) or lower (a discount) than its NAV. The amount of premium or discount is primarily determined by the prevailing demand and supply of an ETF. For instance, during times of excessive demand for gold, the price at which a Gold ETF trades in the market is likely to be higher than its NAV and vice versa.

An Investor Education Initiative by HDFC MUTUAL FUND BHAROSA APNO KA

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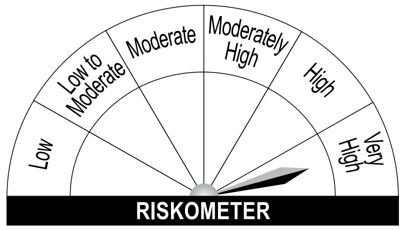
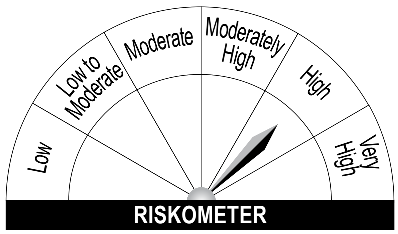
Name of Scheme / Investment Plan	This product is suitable for investors who are seeking*:	SCHEME RISKOMETER#
HDFC Index Fund - NIFTY 50 Plan (An open ended scheme replicating /tracking NIFTY 50 index)	• Returns that are commensurate with the performance of the NIFTY 50, subject to tracking errors over long term • Investment in equity securities covered by the NIFTY 50	 Investors understand that their principal will be at very high risk
HDFC Index Fund - S&P BSE SENSEX Plan (An open ended scheme replicating /tracking S&P BSE SENSEX index)	• Returns that are commensurate with the performance of the S&P BSE SENSEX, subject to tracking errors over long term. • Investment in equity securities covered by the S&P BSE SENSEX.	
HDFC NIFTY 50 ETF (An open ended scheme replicating / tracking NIFTY 50 Index)	• Returns that are commensurate with the performance of the NIFTY 50, subject to tracking errors over long term. • Investment in equity securities covered by the NIFTY 50	
HDFC Flexi Cap Fund (An open ended dynamic equity scheme investing across large cap, mid cap, small cap stocks)	• To generate long-term capital appreciation / income • Investment predominantly in equity & equity related instruments	
HDFC Gold Exchange Traded Fund (An open ended scheme replicating /tracking performance of Gold)	• Returns that are commensurate with the performance of gold, subject to tracking errors, over long term • Investment predominantly in Gold bullion of 0.995 fineness	 Investors understand that their principal will be at high risk
*Investors should consult their financial advisers if in doubt about whether the product is suitable for them.		

For latest riskometer, investors may refer to the Monthly Portfolios disclosed on the website of the Fund viz. www.hdfcfund.com

MUTUAL FUND INVESTMENTS ARE SUBJECT TO MARKET RISKS, READ ALL SCHEME RELATED DOCUMENTS CAREFULLY.

Thank You

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