Silly and Billy on Exchange Traded Funds

by *Sundar Sankaran*[*]

Silly: Hi Billy, my name is Silly. I can talk, even in my sleep, on all aspects of life – except investments, where I am a born loser. I am told that you are a cat in the field of investments.

Billy: Glad to meet you Silly. I know a few things about investments that I share with people like you. Have you ever invested?

Silly: Oh yes. I invested in equities in 1992, bonds in 1994, real estate in 1995, gold in 1997 - and equities again in 2001. I have mastered the fine art of investing when the market is at its highest, and selling when the market is at its lowest! Soon after I sell, the market recovers!!

Billy: Since 2001 your money is lying in your bank?

Silly: Yes. My wife threatened to divorce me if I invested any where else. So these days, I deposit my savings in banks.

Billy: How do you feel about your money in the bank?

Silly: Miserable. Every time a deposit matures, the bank offers me a lower rate of interest to accept a new deposit. I also managed to lose a few deposits maintained with co-operative banks that offered me 1% higher interest. On the other hand, my friends who invested in debt mutual funds earned returns in excess of 20% in the last couple of years.

Billy: I can understand your thoughts. Have you ever invested in mutual funds?

Silly: Please don't tell my wife. I secretly invested my annual bonus in a debt fund in August 2001. Sold them at a loss on September 12, 2001. The wife is still upset with my boss because she thinks I received a lower bonus than I deserved.

Billy: The market recovered after you sold in September 2001?

Silly: A few days after I sold – as usual.

Billy: Have you learnt anything from these experiences?

Silly: I was probably operating like a speculater – or may be a gambler. I should have been an investor, taking a long term view on the markets.

Billy: I am glad sense has prevailed. Equity, debt, real estate and gold are all assets where you may invest. Various assets perform well over different periods of time. You therefore need a mix of assets in your portfolio. Financial investments like equity and debt are generally more convenient and cheaper to buy and sell than physical assets like real estate. So they tend to form a major portion of any investor's portfolio.

Silly: So I should invest in a mix of debt and equity.

Billy: Absolutely.

Silly: How should I distribute my portfolio between debt and equity?

Billy: That depends on your financial position, nature of job, family size and composition, psychological ability to accept losses and such other factors. As a 30-year old well-to-do gutsy professional with a stable job, a wife who is employed, and having no dependents, you can think of maintaining a mix of 75% in equity and 25% in debt.

Silly: Frankly, I do not know much about equity. And I know nothing about debt.

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Billy: That is where mutual funds come in. They will manage your money for a small fee. So you are saved the bother of having to track your investments and taking buy/sell decisions daily.

Silly: There are so many types of mutual funds. Where do I invest?

Billy: A major portion of your debt portfolio could be invested in gilt funds (which invest only in government securities) and bond funds (which invest in government as well as non-government entities). In order to take care of sudden liquidity needs, you could maintain some portion in a Liquid fund (which is likely to give you a return better than a bank deposit, but whose value does not fluctuate much). Your wife will love it.

Silly: In that case, why not invest all my money in a liquid fund? My wife will love me more.

Billy: Generally, the returns in a liquid fund are lower than those on gilt funds and bond funds. Since you also need to provide for future additions to your family and your own post-retirement golden years, you need to earn adequate returns on your total portfolio.

Silly: Therefore you are suggesting equity as well.

Billy: Yes.

Silly: But frankly my wife will not allow me to invest – definitely not in equity.

Billy: Most investors feel more comfortable investing in debt. They think it is safe - forgetting that the ultimate objective of investment is not to earn a return, but to live a comfortable life and maintain standard of living.

Why don't you remind your wife about the trip to the US that she would like a few years down the line? The trip may cost Rs100,000 today. If you invest the same Rs100,000 today in a bank at 8% pa for 5 years, you will have Rs147,000 when the deposit matures. But in 5 years, if the cost of the US trip increases by 12% pa, you will need over Rs175,000. Thus, the US trip that is affordable today is no longer affordable in 5 years.

Silly: How did you generate these magical numbers?

Billy: There is no magic. In the case of a bank deposit or any debt investment, you know the *amount* that you will have in future – but you do not know the *value (worth)* of that amount in future. Inflation is the biggest enemy of a debt investor.

Silly: Does that mean that inflation is a friend of an equity investor?

Billy: Look at it this way. Suppose a company's revenue and expenses go up by 10%, the profit would go up too. When profit increases, the price of the company's equity share too could increase. Therefore, it is often said that equity is a good hedge against inflation.

Silly: But can we be sure that equity will go up?

Billy: No. You cannot be sure. Hence the risk. Therefore the advice to distribute one's portfolio between debt and equity.

Silly: Now I am getting the hang of it. But isn't it risky to invest 75% of one's portfolio in equity.

Billy: Consider your age, personal circumstances, family situation, and desire to scale up standard of living, I believe equity in the range of 75% is appropriate.

Silly: Does that mean that my 70-year old father should not invest in equity?

Billy: Even he should invest in equity. But a smaller portion, say 10-15% of his total portfolio.

Silly: I see. But what type of equity? Recently I read about something called an index fund. What does it mean?

Billy: Mutual funds can launch schemes where they have full discretion on where and how much to invest. These are called *managed funds*. Or there can be schemes where they do not have the discretion. These are called *index funds*.

Silly: Which of them are better?

Billy: There is no single answer. It is up to you. If you hope to earn a return that is better than what is normally possible in the market, you would choose a managed fund where the mutual fund can invest as per its reading of the market and companies. On the other hand, if you are only looking for a return that is in line with the market – and are afraid that the mutual fund may not read the market correctly - then you would choose index funds.

Silly: So in an index fund, the mutual fund announces the names of the companies it will invest in – and keep investing on that basis.

Billy: It is almost like that. But instead of naming the companies, they name an index according to which they will invest.

Silly: I am lost. What is an index?

Billy: Various independent agencies viz. stock exchanges, credit rating agencies, financial press etc. construct indices, which they feel are representative of the market or a segment of the market.
For instance, the National Stock Exchange has an index called NSE CNX Nifty. This is constructed on the basis of 50 blue chip companies. The names of the companies, as well as their importance (weightage) in the index are public information. An index fund may promise to invest on the basis of NSE Nifty – in which case it will invest in those 50 companies in the same proportion as their weightage in the index.

Silly: If the information is public, then why can't I invest in the same manner? Why involve an index fund and pay them for the service?

Billy: An index fund gives you the convenience of investing in the 50 shares through a single investment in a Unit. Further, your investment can be as low as Rs5000, whereas the investment requirement to invest in the 50 shares as per the NSE CNX Nifty will run into lakhs of rupees.

Silly: In my part time management course, I was told that we can buy something called a future, where with a single investment the entire index can be bought – and the investment amount required would be lower.

Billy: Yes and no. By paying a small percentage of the value of the index, you can have an exposure to the entire index. However, you would need to take a minimum exposure of around Rs2lakhs for doing business in the futures market. Further, futures have a maximum validity of 3 months, at the end of which you will have to get on to another futures contract, if you wish to continue your investment position in the index. Whereas, index funds give you the flexibility of maintaining your investment position for as long as you desire.

Silly: When I invested in a mutual fund in 2001, it was quite frustrating. I wrote a cheque for the investment on a Friday. I had to wait till Tuesday to know how many units had been allotted against my investment. Then when I sold my investment, it took me three days to find out how much I would receive for the sale.

Billy: Yes, this happens because Units are allotted on the basis of value of the scheme, commonly referred to as Net Asset Value (NAV). For this purpose, applications are pooled together and allotted units on the basis of the same day's NAV or the next day's NAV. So it is possible that you invested on a Friday, but the next NAV was calculated on Monday. You may have read about the NAV in Tuesday's newspaper. A similar delay could occur when you sell your investment holding.

Silly: On the other hand, if I buy or sell a share, I get to know the value of the trade immediately.

Billy: You have a point there. Exchange Traded Fund (ETF) is a type of index fund that offers you the same flexibility. The fund maintains a portfolio like an index fund. However, you can buy and sell the units of the fund in the market like a share. So you get to know the trade value immediately, and receive or make payment as per the stock exchange's settlement cycle. An ETF combines the best features of an index fund and a share.

Silly: What if there is no trading in the market?

Billy: ETFs are generally liquid, because, as you rightly pointed out, they are an alternative to futures. As you may be aware, trading in futures has taken off well in India.

Silly: Which are the ETFs in India?

Billy: Currently there are two. Unfortunately, their corpus is small. UTI has recently launched an ETF called Sunder. It stands for **S**&P CNX Nifty **U**TI **N**otional **De**pository **R**eceipts. These Units are expected to list in the market on July 14. Thereafter, you can buy them through your broker in the National Stock Exchange.

Silly: How can I be sure that UTI's ETF has a large corpus?

Billy: When the Units are listed, you will be in a position to ascertain the corpus size.

Silly: How much would each Unit be worth?

Billy: The Units are likely to trade in the market at around one-tenth the value of the NSE Nifty index. So, at the current Nifty value of 1100, you can buy a unit at around Rs110.

Silly: That sounds interesting. At Rs110, I am effectively buying 50 blue chip shares.

Billy: That is right.

Silly: But I could still lose money.

Billy: These risks normally increase because investors try to time the market. If instead, on the first of every month you invest Rs1000 in Sunder. Whenever Nifty increases in value, you get fewer Units for your investment. If Nifty decreases in value, your investment would fetch you more Units. Thus, over a period of time your cost averages. This minimizes your risk of losing money.

Silly: Investing Rs1000 every month. Sounds like a recurring deposit that my wife maintains with a bank.

Billy: Absolutely. In mutual fund jargon, it is called Systematic Investment Plan.

Silly: Sounds great. You have given enough tips for me to convince my wife. Thanks.