Our Views

Financial inclusion – passive fund management could enhance financial savings

The massive roll-out of JanDhan bank accounts has surely gone a long way towards financial inclusion in India. As mentioned in my last week's paper, the total balance in the 410 million JanDhan bank accounts is a large sum of Rs. 1.31 tn. With financial inclusion of this magnitude, we need to now focus on improving savings in the country and make available convenient, unspeculative, and low-cost savings avenues which can boost wealth creation. At present, as a country we have Rs. 143tn of deposits with banks, Rs. 27tn investment in mutual funds – this is apart from investments in physical gold and real estate.

Like in other sectors, technology is making its impact in fund management as well and this can provide a fillip to financial savings. Passive Fund Management (PFM) and Exchange Traded Fund (ETFs) could be important enablers which provide market linked returns with transparency and at low cost. These alternatives take away the risk of human judgement and decision making. Its like a driverless car which drives based on technology driven pre-programed inputs.

These funds are managed passively and therefore the annual expenses are significantly lower than the actively managed funds. They provide liquidity - like stock, they are sold at real time prices and trade throughout the day. Being listed on stock exchanges, their cost of distribution is much lower, and the reach is wider. Also, they do not have a minimum investment requirement so investors can invest as per their requirements.

As a result, globally, passive fund management is growing twice as fast as active fund management. It is expected that by 2024, out of the total of ~$106tn under fund management globally, almost $25tn will be managed by way of passive funds. I believe that this trend of movement towards passive funds will continue. Blackrock, the largest fund management house in the world, at the end of 2019 was managing ~$7.4tn, of which almost $4.9tn was being managed by way of ETFs and passive funds. Active fund management constituted only ~$2tn. Passive funds form 65 to 70% of the AUM of fund managers like Blackrock and Vanguard.

Back home, in India as well, passive investing is seeing some traction. Post the launch of the first such fund in 2001, the passive format has grown over time and today there are close to 200 passive management schemes in India with an AUM of ~Rs. 2tn. This forms around 7% of the total mutual fund industry.

ETFs offer a variety of options for investment such as diversified passive equity ETFs, niche passive equity ETFs, debt ETFs, gold ETFs and active ETFs. Additionally, as mentioned earlier, the cost of fund management is almost negligible. A fund management team (driver) is not required - once the technology is set up, it can move on an auto-pilot with a small back office team. The distribution cost is also significantly lower as these are standard products which can be sold online and do not require personalize selling/ marketing. As all costs are debited to the unit holders, any savings will further improve the return to investors.

The combination of a simple product, high liquidity through exchange trading, transparency, ease of trading and lower costs makes passive funds a very attractive option. Today, 84% of mutual fund investment is contributed by top 30 cities. Passive investing/ ETF, if distributed technologically, would make a very popular product for masses across the country. It can change the savings landscape in India and can create liquidity in assets class like government bonds, corporate bonds, commodity like gold etc.

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