

The Rise of Exchange-Traded Funds (ETFs) in the Indian Stock Exchange: Opportunities and Challenges



THE RISE OF EXCHANGE-TRADED FUNDS (ETFs) IN THE INDIAN STOCK EXCHANGE: OPPORTUNITIES AND CHALLENGES

A decade ago, everyone was talking about mutual funds. We see a similar trend around Exchange Traded Funds (ETFs) in India. Though mutual funds are not going anywhere, the popularity of ETFs will increase with time, and the recent growth numbers are proof of it. In this article, we will understand ETFs, the opportunities, and the associated challenges.

What are ETFs?

Exchange-Traded Funds (ETFs) are investment funds that trade on stock exchanges, offering investors an efficient and diversified way to invest in a wide range of assets, including stocks, bonds, or a mix of these, all in a single investment.

Imagine you are interested in investing in the [Indian stock market](#) but don't have the time or expertise to pick individual stocks. Instead of investing in individual companies, you can invest in an ETF that tracks a stock market index like the Nifty 50.

The rise of ETFs in India

In India, ETFs are still in the nascent stage. However, globally, it is a gigantic industry. To give you an idea - the global asset under management (AUM) for ETFs has grown from \$212 billion in 2003 to \$ 9.2 trillion as of May 2022. In this period, the ETF count has increased from 291 to 8,966.

ETFs in India have just started. The AUM in India for ETFs has increased five times since 2018. Since 2021, the AUM has grown at an exceptional rate of 69% year on year. In December 2021, the AUM of the Indian ETFs was only Rs 4.04 lakh crore, which had increased to Rs 5.20 lakh crore in Feb 2023.

In December 2022, there were around 150 ETFs in India, and 41 of them were listed in 2022 alone.

Opportunities associated with ETFs

ETFs present several opportunities to Indian investors due to their unique characteristics and the evolving investment landscape in India. Below are some opportunities for investors in ETFs:

- **Diversification:** ETFs provide you with the opportunity to achieve instant diversification by investing in a single fund that holds a basket of stocks (or bonds). They help you mitigate your investment risk by spreading investments across multiple securities and sectors.
- **Access to Various Asset Classes:** ETFs cover a wide range of asset classes, including equities, bonds, and gold. Investors can easily access different market segments and build a well-rounded investment portfolio.
- **Low Costs:** ETFs generally have lower expense ratios compared to actively managed mutual funds. The cost advantage can result in higher returns for investors over the long term, making ETFs an attractive option for cost-conscious investors.
- **Exposure to International Markets:** Some ETFs listed provide exposure to international markets like the US, allowing you to diversify globally without the need for direct investments in foreign stocks.
- **Simple Investment Option:** ETFs are easy to understand and invest in, making them suitable for both experienced investors and those who are new to the market. They can be bought and sold through brokerage accounts, similar to individual stocks.

- **Transparency:** ETFs disclose their holdings regularly, allowing you to see the exact securities held within the fund. Transparency aids investors in making informed decisions.

Challenges associated with ETFs

Based on our discussion so far, we can conclude two things. First, ETFs are excellent investment options, but they are still in a nascent stage in India. As a result, there are some challenges associated with ETFs that investors must know before investing in them:

- **Liquidity Concerns:** Since not many investors invest via ETFs, the trading volume for some ETFs is low, which may lead to wider bid-ask spreads. It could result in investors buying at a slightly higher price and selling at a slightly lower price, potentially eroding returns. Liquidity is not a concern in popular NIFTY50 and Gold ETFs. However, for newer ETFs, it is a challenge. Before investing in an ETF, check the liquidity.
- **Tracking Error:** ETFs aim to replicate the performance of their underlying index. However, tracking errors can occur due to factors like transaction costs, dividend distributions, and changes in the composition of the underlying index. High tracking errors can lead to discrepancies between the ETF's performance and the corresponding index's performance. Check for tracking errors in ETFs you plan to invest in.
- **No one is selling ETFs:** While the MF industry works on a distribution model, ETFs are sold by stock brokers, not distributors, who find more potential in their earnings by selling equity stocks to customers and getting them to churn. So only those who understand the product and can make decisions for themselves invest in ETFs. Awareness and product understanding will continue to be a leading challenge for ETFs in India.

To Sum Up

The rise of Exchange-Traded Funds in the [Indian stock market](#) brings a wealth of opportunities for investors seeking efficient, diversified, and cost-effective investment options. However, investors must also be mindful of the challenges that come with ETF investing and adopt strategies to navigate them successfully. As with every other investment, investors must educate themselves and understand the advantages and challenges of ETF investing in India.

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