

Title: NIFTY FIFTY and the Kebab Platter

Region: INDIA

Date: 18th June 2010

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Recently, I had a friend of mine from US visiting India for the first time. And as we all do when anyone from US visits us for the first time, I took him to authentic but expensive Indian restaurant for lunch. My friend was fond of food in general, but had never tried Indian food.

As soon as we occupied our table, the restaurant staff came up with the menu card to take the order for food. My friend had heard about Indian Kebabs in US. He sought my advice on it. I quickly moved that responsibility to the restaurant manager, whom I knew very well. The manager blurted out 20 types of kebabs in rapid succession, which he felt that my friend should indulge in, right from Seekh Kebab to Paneer Kebab to Shahi Kebab to Kakori Kebab etc.

My friend was thoroughly confused with the names and was not able to decide on which kebab to order, but was keen on tasting all of them, at least some of them. I thought to myself so many options on kebabs, which one would my friend relish? Should I take the risk of ordering one of the kebabs and my friend not liking it at all? If he doesn't like, each portion which costs around Rs 400 would go waste. Or should I order all which would be much more expensive and again some of everything would go waste. I was not keen to disappoint my friend, yet wanted to diversify the risks of my losses too.

I spoke to the restaurant manager and explained him my dilemma. The manager who was aware that I was in business of money management, said "What do you do in stock markets when you don't know which stock to buy? In my mind the dilemma of kebabs was replaced by dilemma of buying either Infosys or Bajaj Auto or Reliance or ONGC, etc buying or all of them in stock markets? I answered "I would play safe and buy the NIFTY 50 INDEX comprising of a large number of stocks which represent the overall Indian markets and the economy, in order to diversify my risks". The manager smiled and said "That's it, Use the same strategy here, buy the **Kebab Platter**, which will have a small piece of each type of kebab, so that you diversify your risks". And my friend was exhilarated at this decision and my risk was controlled too.

And the lesson that my friend learned from this was "When you can't decide or understand, being PASSIVE IS SAFER THAN being ACTIVE and run the risk of buying wrong stocks and incur losses". The Kebab Platter idea would work with the NIFTY Index (India's Benchmark Stock Index) of 50 stocks too. Since my friend was keen to invest in India but was not very familiar with the economy and individual stocks.

My friend started being inquisitive on relationship between NIFTY and Kebabs.

His first question was "How has the NIFTY Index performed for a longer horizon such as 15 or 20 years"? Using the calculator on my cell phone, I said "NIFTY is up 20 times in last 20 years and the returns (CAGR) excluding dividends is 15.69 %". (Chart I). And dividends would add at least 1% or more to it. He was overwhelmed. He said "The Dow has returned less than 7% in last 20 years". My response to that was "That's Indian Magic". He said "The Nifty 50 stocks looks good"

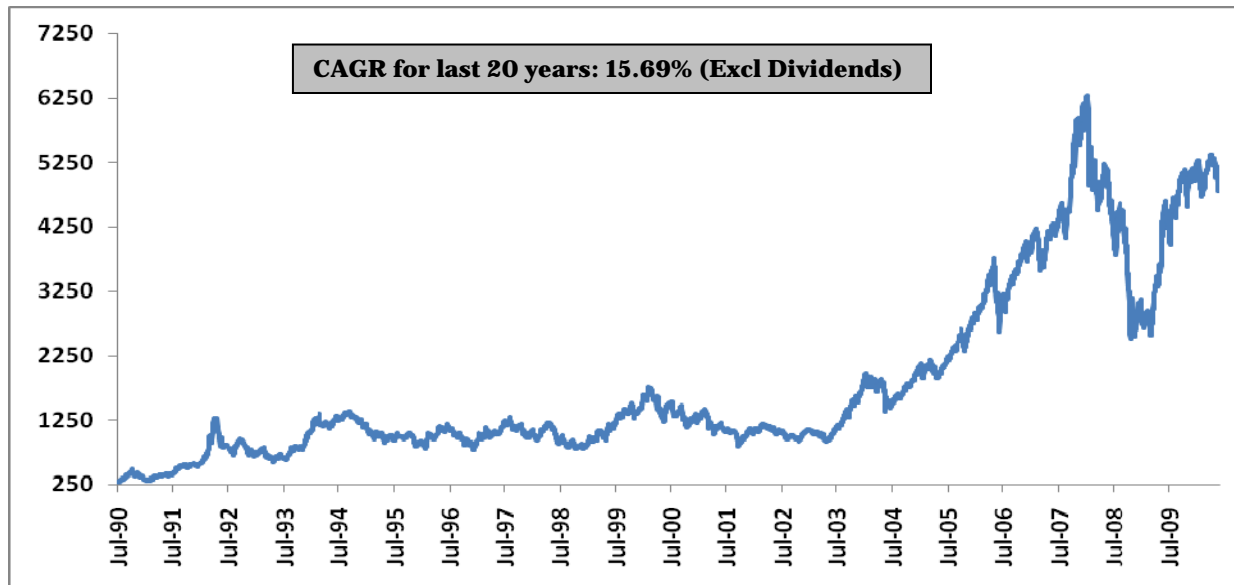
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Chart I: NIFTY 50: 20 TIMES UP in last 20 YEARS



Source: NSE & Delta Global Partners Research (Data upto 31 May 2010)

His next question was “Do we have to go through the pain of buying all the 50 stocks in NIFTY Index in same proportion and at the same time? I said “NO, You can buy an NIFTY Index Exchange Traded Fund (ETF) which is listed on National Stock Exchange (NSE). And the fund will ensure that at all times they replicate the NIFTY index”. I continued “ETFs are better and efficient way to take exposure to any index and they score over open ended Index funds which may not be listed”

My friend’s curiosity was now increasing. Then came his next one “**And what are the benefits of buying a Stock Index fund, based on says NIFTY 50 index?** I said “Loads of them!”

- No pains of doing research in selecting a single stock or sector and taking the risk of the specific stock or sector, which may or may not do well.
- Returns from index funds are similar (subject to fees and expenses) to overall markets-Not more –Not less, like single stock.
- Well diversified exposure to stock markets and economy of India-NSE 50 Index comprises of 50 blue chip stocks spread across various sectors of the economy, so lower risk.
- No need to track the NSE Index portfolio, a committee of eminent market professionals will alter the NSE Index, as and when required.
- No need to track the dividends or any other corporate action from 50 companies, the Index fund would take care of that.

How do these funds, the Index ETF operate? He asked. I was ready” Simple, the fund has market makers as partners (Authorized Participants) who give continuous buy and sell quotes in the fund units on the exchange during market hours. When they sell

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more than they buy, their inventory gets depleted and they go to the fund and buy more units and vice versa. As the fund receives more and more money it buys ONLY the NIFTY 50 stocks in the same proportion, not more not less. Like any other stock such as Infosys, anyone who has a broking and a dematerialized account can easily buy an Index ETF. Sit at home and by using your online trading account or just call your broker, to buy the ETF. It's as easy and simple. A few clicks and you own the NIFTY Index of 50 stocks which will sit in your dematerialized account.

So, JUST RIDE THE INDEX, which is known as the "Passive" strategy vis a vis an "Active" stock selection strategy where the fund manager buys stocks which he likes and sells which he doesn't like"

I thought I should let my friend know more on the **benefits of Index ETFs** which are ample:

- Easy buying and selling- Easy liquidity during market hours on NSE.
- Real time buying of Index stocks, unlike managed or active funds where end of the day NAV is offered to the investor. This ensures transparency too.
- Lower expense ratio, being a passive fund, there are lesser costs incurred in managing the fund.
- Lower Transaction Costs due to lower portfolio churning, which limits the "impact cost" for the fund. Portfolio Churn is induced only by mandatory re balancing of the portfolio to align it with changes in underlying index.
- Diversified Exposure to markets and the Indian economy with 50 stocks in a single unit.

My friend was certainly impressed. He continued with his questions. And yes- **how are Index ETFs (passive) are compared to diversified equity (active) mutual funds?** Why should not I invest in diversified or the active mutual funds? My response was -

- An Active fund would pick stock at the fund manager's discretion-whether the investor in the fund likes it or not- But an Index fund would only buy the index stocks, nothing else, no guess work, no brain work. The Index fund investor would exactly know when and which stocks his fund will buy.

Moreover a few advantages on Index funds over actively managed funds -

- Studies show that 80% of the fund managers in USA have underperformed the S & P 500, a leading stock index in USA.
- Fund managers cant outperform the index in long run on a sustained basis, the excess returns over index known as "Alpha ", tends to be lower in efficient markets. And India is progressing towards being a more efficient market.
- Why pay higher fees to managed fund and take a risk on fund managers judgment or stock selection skills. This risk is also known as "Fund Managers Style Risk"
- Diversify and Hedge the managed funds exposure-Hedge active with passive.

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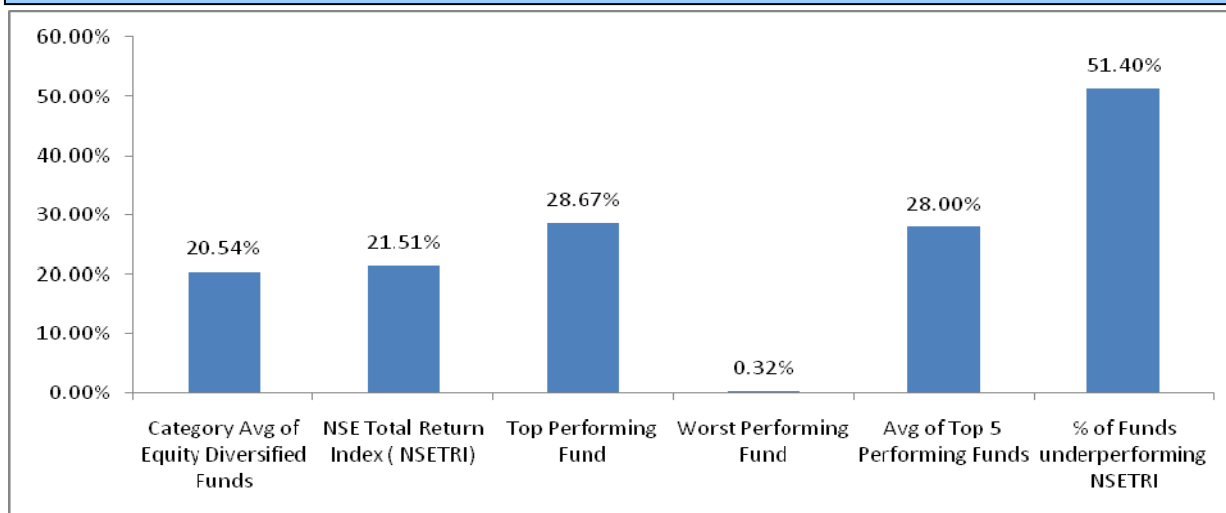
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I thought I should give my friend a better view on the **advantage of being passive over active in the Indian context.**

We compare returns on NIFTY Total Return Index (including dividends) with the average of returns of Diversified Equity Funds for last 5 years. The NIFTY Total Return Index is used for comparison since the dividends received by the funds are also included in the returns (Net Asset Values) of the fund. (Chart II).

Chart II: Active or Passive? Which is better? Part I



Source : www.valueresearchonline.com. Data for Diversified Equity Funds Category for 5 years ending 18th June 2010

For the last 5 years NIFTY Total Return Index (NSETRI) has returned 21.51% (including dividends), which is higher than the Category Average of Diversified Equity Funds (around 107 funds). And 51.4% of the funds have not been able to outperform NSETRI. Would it make sense to pay more in fees and take more risk (if the fund manager takes wrong call on his stocks) to earn lesser returns than the NIFTY Index?

There are two issues here. First is the fact that the returns should be compared on a risk adjusted basis. Though the risk can be easily quantified in the NIFTY 50 Index, it will be a little difficult to arrive at one single figure representing comparative risk in all the funds put together. The other issue is the fact that the NSE TRI return is a gross one and the return of the funds is a net one viz after deducting the expense ratio. Even though we add the average expense ratio of 1-1.5% to the category average returns, the difference in the returns from the funds and NSETRI will be marginal.

The result obtained by a study done by CRISIL of performance of active and passive funds in India further reinforces the above conclusion. (Chart III below). 71% of the Large Cap Funds have not been able to outperform the Nifty 50 underlying index.

Ok, now my friend was becoming a little smarter. **He asked “And how does two NSE 50 Index fund differ from each other, if both of them buy the same underlying NSE 50 stocks?”** That was my friend’s last arrow, nevertheless was a good

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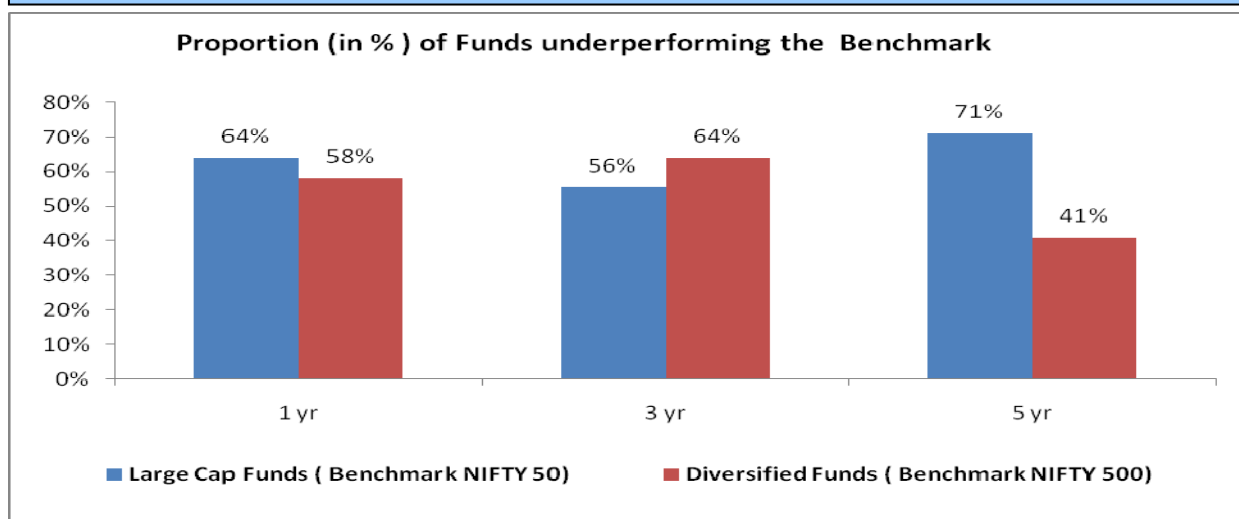
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question: I asked him a question back , “If you are getting a standard 100 gm Nestle Chocolate pack in an grocery shop at Rs 100 and the same pack is available in the next shop at Rs 90, which one would you buy ? “His instantaneous answer was “Rs 90 one of course, why I should pay more for same pack “. “Very True!”, if all the NSE 50 Index ETFs will be buying the same underlying stocks, what would matter is the Expense ratio (to cover fees and expenses) of each of them or the costs incurred by the fund. Lower the expense ratio, closer will be the ETFs return to the underlying NSE 50.

Chart III: Active or Passive? Which is better? Part II



Source : CRISIL SPIVA Year end 2009

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So when one compares various Index ETFs, these points have to be considered:

- Lower the expense ratio (50 bps or so) more will be the portfolio money invested in the underlying index. Lower Cash Balances in the portfolio will have the same outcome.
- Tracking Error has to be as low as possible. Tracking Error is the extent to which an Index fund is not able to exactly replicate the returns from the underlying index. Tracking error is also a function of rebalancing policy adopted by the fund managers.
- The policy on dividends which are received by the fund are re invested in the fund or not, has an influence over the tracking error too.

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-The fund managers track record in managing index funds. Since last thing that an index fund needs is a fund manager who starts taking calls on markets, instead of sticking to the index stocks in the same proportion. So whenever the tracking error is positive by a large number, be cautious on the index fund.

I was also keen that I give a global view of Index Funds to my friend. Globally, the index funds mainly ETFs are based on variety of underlying indices pertaining to asset classes such as equities, commodities, fixed income, real estate etc. ETFs are flexible and can be classified from the market capitalization perspective or geographical bias or on leverage etc. The estimated size of global ETFs is USD 830 bn, making them a force to reckon with.

Though my friend finished his lunch made up of kebab platter, his plate continued to be full of ideas pertaining to Index Funds and ETFs. He told me “Buy Index Funds and Sleep Well”. After a few minutes I did see him logging on to his online brokerage account.

And I thought it would make sense to buy the NIFTY index ETF now since the market has already risen more than 100% from its March 2009 lows and if one is not sure where it will go from here or which specific stocks to buy now. If markets in general fall sharply from here, a single stock or a non diversified exposure will carry more risk than the overall NSE index.

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