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# WHAT KIND OF RETURNS TO EXPECT FROM INDEX MUTUAL FUNDS? ALL YOU WANT TO KNOW

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

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With less and less time available for us to make and monitor our investments, passive investing is becoming a trend of late. Index investing is a major avenue for making passive investing. In this article I wish to explain all about index funds and as to why you should invest in them.

**What are index funds?**

An index is a representative movement in the value of items in a particular group. So we have indexes for various segments of the equity market to reflect the movement and trend of prices shares of the segment they represent. There are many indexes to represent various categories and sectors like large cap, small cap, consumer goods, banks, realty infrastructure etc.

An Index fund can be defined as a scheme which has as its components all the constituents of the index which it is tracking, referred to as parent index hereinafter. Since an investor cannot buy an index directly so to help the investor replicate and invest in the specific index mutual fund houses have created various index funds.

These funds hold various stocks in the same proportion as in a parent index, meaning that the scheme will perform in tandem with the parent index with some minor difference known as tracking error. Please note that the index funds are not supposed to outperform but merely mimic the performance of the parent index, as close as it is possible.

Most of the equity schemes are actively managed by the fund manager to generate better returns than its benchmark but Index Funds are passive funds where the fund manager just replicates the composition of the parent index. Since the fund manager just has to replicate the portfolio of the benchmark index it neither requires expert fund manager nor frequent churning is needed in the investment. Both these factors help the fund lower the overall costs for the index fund. Due to lower fund management expenses sometimes index funds are able to score over the actively managed funds especially during less volatile market conditions.

The markets in developed countries are more efficient, transparent due to quick dissemination of information and strict regulatory compliances and monitoring as compared to developing countries like India. This infirmity leaves scope for some level of insider trading opportunities and selective information leak and thus helps actively managed funds perform better than passive funds. Please note that actively managed funds, in due course, no longer will be able to beat the broader market index funds consistently.

**What is tracking error and index funds have tracking error**

All funds have to maintain some cash to meet the redemption demands thus resulting in under deployment of funds. This causes deviation between actual returns of the index fund on either side depending on movement of the parent index. This deviation is called tracking error. Lower tracking error portrays efficiency of the performance of the index fund. So the best index fund is which has zero tracking error. Positive tracking error also reflects on the fund manager’s call on

the market, which the fund manager is not supposed to do.

**Why should you invest in Index Funds?**

These funds are ideal for people who wish to invest for long term to reap the potentials of equity to generate higher returns but are not able to spare enough time to execute their transactions and review their portfolio and also do wish to avail services of investment advisors. So in case you are busy pursuing your career but want to accumulate your fortune, you should invest in index funds as the index funds broadly mimic their parent index which is expected to go up in the very long run. The index funds are also ideal for an investor who does not want to take risk associated with a fund manager as for an average investor it is not possible to track the movement of the fund manager from the scheme or the fund house. Many schemes experience deteriorating performance once the star fund manager leaves the fund house/scheme. In case of an Index fund you need not worry about the fund manager as the manager does not have any significant role in performance of an index fund.

**What type of index funds one should invest?**

Since there are many index funds tracking various benchmark indexes, a lay investor faces the problem of plenty. So a lay investor who wants to invest for long term goals like retirement or child education/marriage should invest in an index fund which covers the broader market. There are various indexes tracking specific segments, themes, industry etc like large cap, mid cap or small cap, banks, consumer durables, health care, information technology, etc. it is advisable to diversify the investment through broad based index funds ideally large cap funds. A broader index fund provides broad market exposure, low operating expenses and low portfolio turnover.

While selecting an index fund in a particular category; please select the index fund scheme which has lowers tracking error, which reflects the efficiency of the operations of the fund. An ideal fund would be Nifty Index Fund or Nifty ETF Fund or a Nifty Next Index fund with least tracking error history.

*(The writer is a tax and investments expert and can be reached at jainbalwant@gmail.com . Views as expressed by the writer.)*

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