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Why investing in passive funds can be a good diversification strategy

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Synopsis
The debate over whether investors should use active or passive strategies in their portfolios has traditionally been viewed through the lens of outperformance. In reality, both can co-exist in a portfolio where an investor can follow a blended approach.

Markets are getting efficient over time and now active funds are finding it hard to beat the benchmark indices.

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At a time when the market was reeling under the effects of Covid-19 pandemic, passively managed products have seen a massive rise in popularity. Ranging from index funds to exchange-traded funds (ETFs), passive investments gained ground in terms of both investor interest and assets under management. Since Jan 2020, the average AUM for index funds almost tripled to Rs 240 billion and ETFs, including gold ETFs ballooned 1.7x to Rs 3 trillion (source: AMFI). This traction was also driven by a plethora of index funds and ETFs being launched by several fund houses over the past couple of years.

Let us understand the difference between active and passive investing. The fund manager in an active fund decides in which stocks, sectors, geographies, etc he should invest the fund's resources and has a clear objective to beat the benchmark index, whereas a fund manager in a passive fund will not have any major active role in the investment strategy as the fund replicates the selected benchmark and hence mirrors the returns as well.

Markets are getting efficient over time and now **active funds** are finding it hard to beat the benchmark indices. According to data from **SPIVA** (S&P Indices versus active), as of December 2020, 87.95% of largecap funds underperformed the BSE100 index in a period of five years. Even on a 1-year basis, 80.65% of the funds underperformed. Passive funds, which mimic returns of indices, have emerged as a strong alternative to investing. Performance apart, passive funds are low cost as the fund management expenses are far lower. An investor having a long-term horizon will consider the expenses associated with it as it will add up on a compounded basis.

Owing to the increased levels of awareness, digital adoption and product innovation over the years, investors have begun appreciating the potential of ETFs. ETFs combine the trading flexibility of a stock, coupled with diversification and low costs of a mutual fund. The fact that ETFs offer exposure to a basket of stocks at a fraction of the amount and have several advantages compared to direct investing, are factors which have helped elicit a favourable response from new age investors.

The risk of active funds failing to deliver can be mitigated by the right diversification (even within the same asset class) and allocations among stocks to achieve returns. Passive investing is predominantly a product for investors who are looking for simplicity, cost-effectiveness and do not want the complications of identifying the right funds. Apart from the innate advantages of being low-cost, passive funds also provide an opportunity to invest in a diversified portfolio by replicating the weights and returns of the underlying index, thereby reducing risk and volatility.

Apart from the plain vanilla index and ETFs, theme-based-ETFs favouring thematic ETFs, which helps in diversifying their holdings.

The extent of presence of either in an investor's portfolio would hinge on your risk appetite and understanding of the market. For novice investors, index funds make more sense than aiming for outperformance. Such investors could keep low-cost passive funds as their core portfolio and supplement it with well-chosen active funds to fetch additional returns.

However, gradually as the investor gains experience, passive investing should be seen more as an asset allocation tool. Investors can create a diversified portfolio mix by allocating some part of the equity in ETF or index funds, which somewhat ensure less volatility in the investments and have some part in it and the remaining would be through active investing.

With growing inflation and expanding economies, it is essential for all investors to upgrade their portfolios to beat inflation and fetch competitive returns. To achieve diversification with minimal efforts, passive funds are available.

The debate over whether investors should use active or passive strategies in their portfolios has traditionally been viewed through the lens of outperformance. In reality, both can co-exist in a portfolio where an investor can follow a blended approach. Having said that, investments in ETFs and index funds help mitigate the risk of underperformance of actively-managed schemes.

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