Exchange Traded Funds & Index Funds

Although Index mutual funds and Exchange traded funds looks similar but they in real term they differ in various aspect.

Index mutual funds have been around for quite some time but the popularity of Exchange Traded Funds (ETFs) among retail investors is rising. ETFs and index funds are simply 2 different ways of investing in a similar portfolio of shares. Both have their own advantages and disadvantages. We will examine some parameters to know which one is best suited for you.

Structure

ETFs - An ETF is made up of stocks making a particular index like Sensex or Nifty. Each of the stock would have the same weightage as it has on the index. Some portion of its assets may be held in cash or money market securities for liquidity purpose. Returns of an ETF are usually close to that of the index. However since the percentage of debt or liquid assets varies with ETF so does return from different ETFs thought they all track the same index.

Index funds - The portfolio of index funds also replicates a stock exchange index. Since index funds have no liquidity of their own, usually they have higher percentage of assets in cash and liquid securities than ETFs. Therefore this leaves for what is known in industry terminology as 'tracking error'. Higher the tracking error, greater the deviation from actual index returns (in any direction).

The table below shows 1 year returns from different Nifty ETFs and Nifty index funds for comparison

Nifty ETFs	Return
BSL Nifty	24%
KotakNifty	22%
Goldman Sachs Nifty	22.7%
Index Funds	**Return**
Canara Robeco Nifty Index	22.4%
HDFC Index – Nifty Plan	23.2%
IDFC Nifty	24.25%
Reliance Index Nifty	23.85%
UTI Nifty Index	23.25%

Most of the index funds as well as ETFs listed above had close to 100% in equities. BSL Nifty had about 5% in cash and cash equivalents, which could be the reason why it gave higher return. So even with ETFs return depends on whether that particular ETF has low tracking error.

Transacting

ETF - ETFs as the name suggest, are bought and sold on the exchange. So you need a demat account for investing in ETF. Minimum one unit of the ETF has to be bought and it is done in the same way as shares are bought through a broker.

Index fund - These are mutual funds and units can be bought lumpsum or periodically through SIP. Automating investment through SIP is a strong advantage you can get through index funds.

Charges

ETF - There are no recurring charges in case of ETFs. Apart from the annual maintenance charge (1%) on your demat account the only other charge is transaction charge of maximum 0.5%. Overall charges in an ETF would come to be about 0.5%.

Index fund - This is the worst demerit of index funds compared to ETFs. First there is the fixed transaction fee of Rs 100 for all investments above Rs 10,000. Second there is a recurring AMC charge called as expense ratio which presently ranges from 1% -1.8%. This is deducted from your investment even if there are no transactions. Finally if you redeem investment before exit period a flat percentage is deducted as exit load. This can be ignored because anyway index funds are supposed to be held long term.

There is however a way to dodge some of these charges in index funds. Direct investment with the AMC does not involve transaction fee and expense ratio of such plans are also lower. Since direct was introduced only in January 2013 we are not sure how much the difference might come to.

Conclusion

Since the great advantage ETFs have over index funds seems to be in cost, we suggest if you have a demat account you invest through ETF. Since SIP is not possible, you'd have to motivate yourself to invest in a disciplined manner. Others can choose SIP in direct plan of index funds of one of the top AMCs.