Title:

EFFECTIVENESS OF INDEX FUNDS IN INDIAN CAPITAL MARKET.

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ABSTRACT

Complexity of Investment decision-evaluation of investment avenues, led to the existence of the mutual funds. This research topic is focused on mutual fund schemes with special reference to performance-return of **Index fund (Passively managed fund)** and **Balance fund (Actively managed fund)**.

Research objectives are identified and achieved through both secondary and primary research. Main purpose was to evaluate both the types of funds keeping in mind the return aspect. Secondary research has been done with the help of books, websites, journals etc. Towards primary research suitable methodology has been developed and followed. Sample mutual fund organizations have been chosen based on non probability based sampling technique-convenience sampling technique. Author approached to branches of mutual fund organizations like ICICI Prudential & HDFC Mutual fund. Qualitative data has been collected from the managers of the above mentioned mutual fund branches. Quantitative data related to the performance of actively managed fund and passively managed funds were collected and analysed first, then opinion of the mutual fund managers has been collected towards behavior of the both the types of the funds.

As a conclusion it has been derived that index fund (passively managed fund) is mainly considered as performance reflector in real sense because **index** constitutes mixture of the industry and all the companies participating in the formation of index are the leaders of their industry concerned. So index fund reflects and can provide the very good return to the investors. As far as actively managed fund is concerned it is the experience of fund manager and decision of fund manager that involves frequent picks and drops of the shares in the portfolio to get the maximum **return** and beat the index. So actively managed funds are based on the assumption of efficient market. The **hypothesis of efficient market** says that share price behaves randomly because information related to all the aspects of share price, activities of the companies, economic performances are available to the investors. So beating index fund all the time is difficult so it gives higher return to the investors compared to actively managed funds.

INTRODUCTION

Background Information:

Saving is very positive word for any economy. Life style, Living standard etc depends upon saving of an Individual and corporate. People or corporate enhance their income compared to expenses and part of that save for the future usage. People increase their saving for future usage but on the other hand they expect their saving grow as well. So people invest their savings into different investment avenues available to them. Banks, Post offices, Companies deposit schemes, other financial institutions, Investment in equity and Debt fund, Mutual fund etc are the some of the examples of the avenues.

Choice of different investment avenues is depending upon the requirements or financial objectives of the individual. This is because required rate of return and risk bearing ability of individuals are different. There was a time when people use to prefer banks and post office schemes only. But now scenario has been changed and people investing directly in shares debentures and through mutual fund organizations keeping in mind maximizing their wealth.

Investment process and Types of Mutual fund Products:

Process: Mutual fund organisations generally invest money on behalf of their clients (Individuals and corporate etc) in different types of funds or scheme they have. They invests bulk fund into financial securities and revenue generated through these investments is divided among its unit holders in proportion of their holdings. Types of securities mutual funds deal in is ranging from shares, debentures, and instruments of money market as well

Types: There are two basic types of mutual fund schemes – Equity schemes and Debt schemes. Further there are many sub categorization and combinations like, Diversified Equity Funds, Sector Funds, Index Funds, Equity linked saving schemes, balanced fund, Bond funds, Gilts funds, shot term funds and Liquid funds etc. There are some emerging funds these days – Gold fund and Real estate fund. In this research work main focus has been given on Index fund.

Aim and Objectives / Research Questions:

Overall purpose (aim) of this research is to evaluate passively managed fund-index fund in context of actively managed funds of Mutual fund from the view point of return.

Objectives:

- To explore the mechanism of managing Index Fund in mutual fund organizations.
- To compare the return of Index fund with actively managed fund.

Research Questions:

- What are the differences between index fund and Balance fund?
- What mechanism is being followed in managing Index fund by Mutual Fund Organizations?
- Does index fund perform better-than actively managed funds? If so How?

LITERATURE REVIEW

Background:

The objective of this secondary research is to collect secondary informations and data that help comparing the investment avenues in terms of investment in mutual fund with special reference to index fund and balance fund. The scope of comparison is return and risk associated with the fund concerned.

Investment decision is major decision for everyone, whether it is an individual or corporate. Expected return from investment might differ for different investors but every investor have common objective that is wealth maximization. The reason behind different expected return is different cost of capital or opportunity cost. Actually wealth maximization is depends upon the right investment decision of the investors.

As per P.Chandra (2008) Investment is a sacrifice of current money or other resources for future benefits. There are many investment avenues available to the investors today. Investors can deposit money in the bank, or purchase a long term government bond, or invest in the shares of a company, or provident fund account. Not only these, even an individual or corporate whoever invest their money in to stock option or acquire a plot of land etc is also an Investors.

In the field of investment the only two key aspects are there in any investment that is time and risk. Sacrifice of an investor is certain and it is current happening but return is the matter of uncertainty and it’s concerned to future. In the long run economic well-being of an investor is depending upon how wisely or foolishly an investor invests money in the available investment avenues. P.Chandra (2008)

Investors can invest their money directly to the option available to them or they can use expert's opinion of investment. Investment avenues other than stock market are very static and that does not required much analytical still to evaluate the investment proposal. Investors those who wish to have fixed return at less risk can invest in the government bonds and other schemes like post office schemes and bank deposits. But investors those want to invest their hard earned money in to stock market- equity shares that required understanding of price movement and condition and trend of stock market and economy as a whole. This is because risk is very high in this avenue of investment similar to its return. But investors can get good return by bearing high risk if they investing their money wisely. So here is the need of an expert who can suggest or invest on behalf of investors to invest in the right equity share at the right time. This kind of services is being provided by mutual fund organizations.

Mutual Fund

"An investment vehicle that consists of a pool of money raised from numerous participants with the intention of investing in securities like stocks, bonds, money market instruments, and similar assets Money managers run mutual funds, investing the fund's money in an effort to increase capital gains and provide income for the fund's investors. The portfolio of a mutual fund is set up and kept up to date in accordance with the specified investment goals in the prospectus.".

So based on the above definition of mutual fund it can be said that mutual fund is a trust which gets savings of individual investors (mainly) who have the common financial goal of getting good return at lowered risk. Risk is low because collected funds from investors are being invested in different types of instruments-shares, bonds etc.

Put it differently this is an organization that they provide services to the investors to invest their fund into money market instruments and capital market instruments like equities, bonds etc. Mutual fund organization offer services on the behalf of their investors and experts in the organization manage the fund of the organization as per the investment objectives stated in the prospectus of the mutual fund. There is involvement of many entities in the mutual fund organization that is the reason this appears safe investment avenue. Sponsors of mutual fund includes promoters of the organization, asset management company-approved by SEBI, Trustees, custodian, Transfer agents, Distributors, Professional management-fund managers,

Mutual fund schemes:

There are many schemes available in mutual fund companies; basic categorization of mutual fund is Open ended and close ended funds. Within these two category funds can be growth fund, income fund, flexible fund, Index fund, Debt fund, Gilt fund etc.

Index Fund-Passive Managed Fund:

Index funds are considered to be passively managed. The manager of an index fund tries to mimic the returns of the index it follows by purchasing all -- or almost all -- of the holdings in the index. Mutual funds and exchange-traded funds allow investors to purchase shares in hundreds of market indices."

Index funds are considered passive investments since their managers cannot manipulate them like they could other funds.. Index fund is related with the Index. Index tells us the direction of market and trend as well. As far as Index funds are concerned, in simple language index fund is a scheme or product of mutual fund that is depending upon the index which reflect the performance of the market. It is said for the index fund that beating market without raising risk is not possible. This concept is known as Efficient Market Hypothesis in Finance.

Efficient market Hypothesis is just opposite of technical analysis. Share price movement can be analysed by fundamental analysis-analysis of economy, Industy and company. Analysis of share price movement can also be done by technical analysis-Assumption of technical analysis is that the past behavior of share price indicates the future behavior of share price. Efficient market Hypothesis is a critic of technical analysis. As we know that basic assumption of technical analysis is that stock price movement is orderly and not random. So this efficient market hypothesis says that stock price movement is not orderly rather it is random. Kevin (2008)

The truth is that a majority of mutual funds fail to outperform the S&P 500. The exact stats vary depending on the year, but on average, anywhere from 50%-80% of funds get beat by the market. The main cause of this is the expense ratio of mutual funds. The overall return of the portfolio less the management and fund expenditure fees paid by the investor is the return of the fund. If a fund charges 2%, then you have to outperform the market by that amount just to be even.

"Here's where index funds enter the picture. Their main advantage is lower management fees than you would get from a regular mutual fund. An average non-index fund has an expense ratio of around 1.5%, whereas many index funds have an expense ratio of around 0.2%. Investing in an index fund doesn't guarantee that you'll never lose money. In both bull and bear markets, your value will fluctuate. The S&P 500 has historically returned between 10 and 11%, which is a respectable amount. Here, being committed over the long haul is crucial. Selling out of fear during a downturn will undoubtedly cause you to miss the comeback.”.

<u>Other than Index fund-Actively Managed Fund:</u>

Actively managed funds are those funds that are actively managed by the portfolio manager by picking specific share and do investment. This kind of fund are totally managed by the fund manager so fund manager always try to beat the market by using its skills so that return from the investment can be more than the market return-return of index fund. In actively managed fund there is potential to outperform the market over index funds. In index fund outperform is not possible because its nothing to do except deciding to invest in index fund but in actively managed fund it is the fund manager who can utilized or use the skills and pick the such share that maximized the return and beat the market index. So this ability to outperform attracts to the customers wish to invest their money into mutual fund.

“The potential to outperform the market is one advantage that actively-managed funds have over index funds, and this notion of outperformance is attractive to investors. Why, after all, would you choose an index fund when you already know that the manager will only earn the market return, less a little fee? Unfortunately, it is rare to discover proof that actively-managed funds can regularly exceed their corresponding index. Finding the actively managed fund that will outperform the index in a given year is much harder for an individual investor.

<u>Whether index fund performs better or other than Index fund-Actively managed fund</u>:

It is a matter of discussion whether index fund perform better or actively managed fund? In other words if we consider Actively managed fund outperform than Index fund then question arises is it efficient market hypothesis that seems true? Or it is simply luck that made it possible. It has been seen that some actively managed fund beat their indexes so there may be a thought not to invest in Index fund and simply invest in actively managed funds. But it is totally the skill of fund manager that made it possible. But some empirical evidence suggests that it is impossible for fund manager to beat the index fund continuously. “Only 41.6% of actively managed U.S. large business funds that outperformed the S&P 500 in a given year from December 31, 1992 to December 31, 2007 were able to do so the following year. Only 9.7% of the initial group was still outperforming the index after three years. For actively managed small cap funds and emerging market funds, the statistics are comparable”.

There is an issue of cost in managing funds. Actively managed funds are costly affairs compared to Index fund. Average management expenses of actively managed funds are almost more than 1% more than of its passively managed funds. This is one of the biggest reason why index fund out perform and actively managed fund underperform than the Index fund.

Another reason why index fund seems better is consideration of capital gain taxation. In the case of actively managed funds fund managers always try to get extra returns so they buy and sell stocks many times so this leads to enhancement of turnover so there will be high turnover and there will be tax on capital gains. Which is not the case of Index fund. So it is the index fund that attract Investors.

METHODOLOGY

Research Design- Author formulated the research questions and aim and objectives of the chosen topic and developed strategy to collect the data from the relevance source. Broader area of research is Mutual Fund organization and specific to- Index Fund and Balance fund.

Specifically research design, author has chosen mutual fund organizations- HDFC, ICICI and SBI Mutual Fund. Data related to Index and Balance fund has been collected from Delhi Branches.

Towards secondary research author referred books on Portfolio management and investment decisions, Books on financial management, related journals, web based information etc to get the up to date information. Secondary research has been discussed in the literature review section-second chapter of this paper.

Primary Research Approach:

In order to conduct primary research author has identified population, out of which sample has been selected by using non probability based sampling technique i.e., convenient sampling technique.

As the area of research is two basic funds of mutual fund i.e. Index fund and balanced fund, so two mutual fund organization has been chosen and both the product has been evaluated based on the past data.

Sample Size:

Sample size of this study: sample size is number of sample taken for the study. For this research purpose two mutual fund organizations has been chosen from the list of population and study has been conducted.

Sampling Methods and Techniques:

There are four types of sampling methods:

- simple random sampling
- stratified random sampling
- cluster sampling
- Systematic sampling.

Author chosen non probability based sampling techniques and within the non probability based sampling technique “convenience sampling technique has been used to choose sample from the population. The reason behind choice of this technique is convenience only- convenience in conducting interview with the manager concerned of the mutual fund organization.

Data collection approach (choice of instruments of data collection) used in this study: quantitative data has been collected from secondary sources but qualitative data– response of managers concerned has been collected with the help of questionnaire placed to the managers concerned of two chosen sample mutual fund organization. The reason behind choice of this instrument of data collection was its features and availability of managers of the mutual fund organizations. As per their busy schedule it was very difficult to organized face to face interview with them. So author preferred questionnaire as instruments of data collection. Questionnaire were placed first and asked them to filled and put on reception of the organization concerned so that author could collect on the next day of placing questionnaire.

CONCLUSION AND RECOMMENDATIONS

Based on the secondary research and primary research (analysis given in the appendix section) author would like to discuss the findings of this research. Author has explored the mechanism of the managing index fund of the mutual fund. In the index fund there is nothing to do to the fund manager as market reflects the performance of entire industry and index is made up with all the industry leader companies representing respective industries so performance of the index can be considered as the real and actual fact of the economy, industry and company. So mechanism of index fund is nothing but it is computer managed system that picks the stocks performing well and leading the respective industry. Unlike actively managed fund managers of mutual fund do nothing towards selection of stocks.

It has been seen that index fund is totally based upon the mechanism of the index and other than index fund (actively managed fund) is depends upon the skill of the fund manager of the fund concerned. Actively managed fund outperforms the market –index fund. It is the skill and managing of the fund manager that make it possible. Efficient market hypothesis is the concept applies here that though index fund reflects performance of entire industry but it is the actively managed fund that can beat the market. It is not always possible but it is the skill and managing capacity and accurate forecasting and quality of decisions that leads to happening of efficient market hypothesis. Efficient market hypothesis says that there is nothing to do with the past trend of the market and industry etc as information related to the share price movement in the stock exchange, corporate development and happenings and industrial development and news related to the industry etc everything is readily available to the investors so price movement is totally randomly done. Price of the share may change as there are changes in the economic, industrial and corporate happenings.

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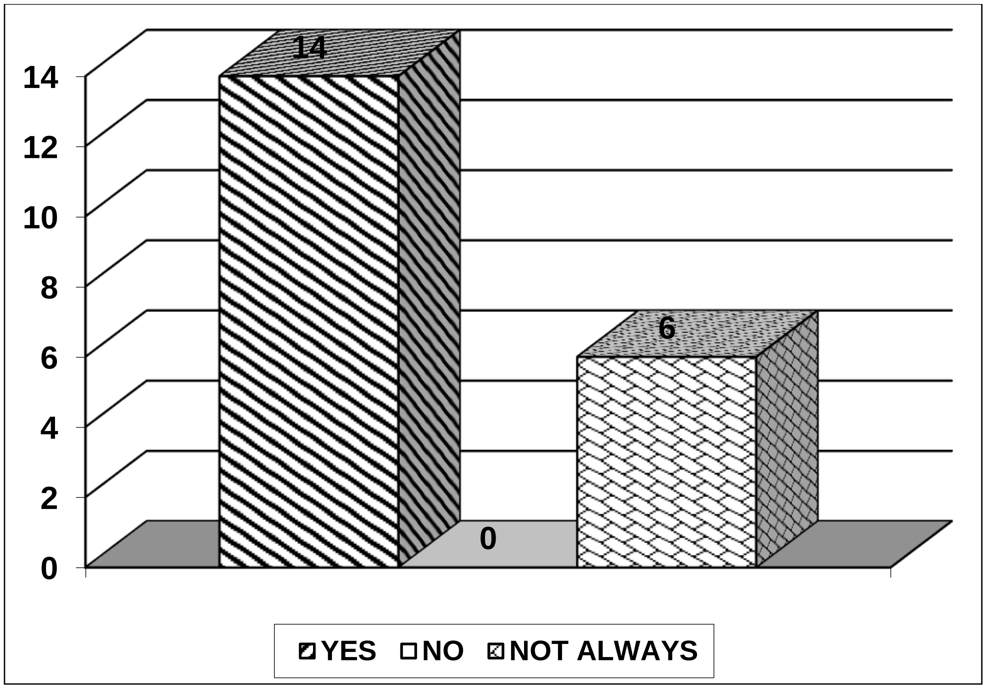
APPENDIX

ANALYSIS AND DISCUSSION OF FINDINGS

Question No. 1: In your opinion does Index fund gives more return than managed funds if investments are made in typical Industry segment (e.g. Bank, Retail, Metals, and Real Estates etc)?

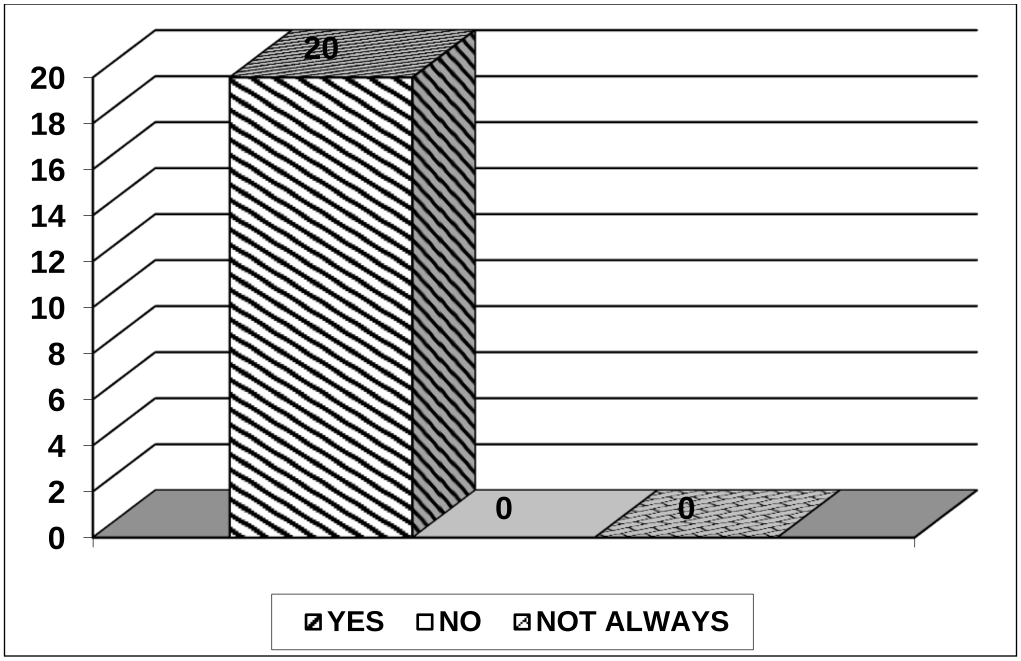
OPTIONS	REPLY	RESPONDENTS	PERCENTAGE
YES	14	14	70%
NO	00	00	00
NOT ALWAYS	06	06	30%



In the above question most of the respondents are agree that it is true that index fund will give more return than the actively managed fund. But it cannot be taken as granted because there are 30% respondents who are saying that it is not always true, that index fund will give more return than actively managed fund.

Question No.2: Do you believe that managing part is very less in the Index fund compared to balanced fund? (Please tick your answer in the appropriate box given below).

OPTIONS	REPLY	RESPONDENTS	PERCENTAGE
YES	20	20	100%
NO	00	00	00

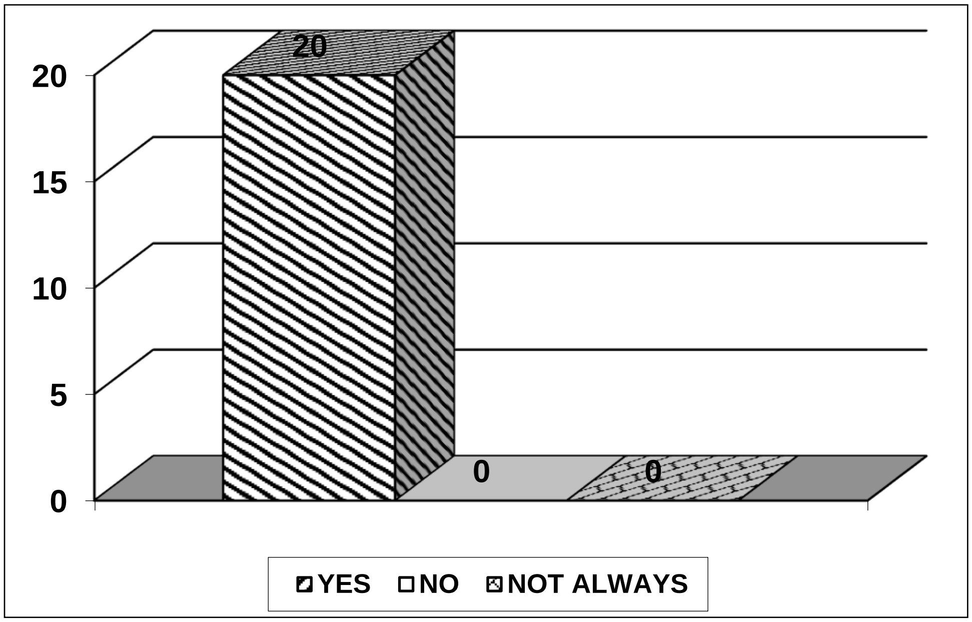


As per the nature of Index fund all the respondents are saying that it is index fund where managing or use of skill by the fund manager is nothing. Index fund perform on the basis of progress of index which combines weightage of most of the industry. Other than index fund-actively managed funds performance is based on even skill of fund manager as well, this part will be discussed in the latter stage of the questionnaire.

Question No.3: Do actively managed funds CAN Outperformed compared to Index fund? (Assumption is return to be considered for the same duration of investment for both the fund) Please tick your answer in the appropriate box given below.

OPTIONS	REPLY	RESPONDENTS	PERCENTAGE
YES	20	20	100%

NO	**00**	**00**	**00**

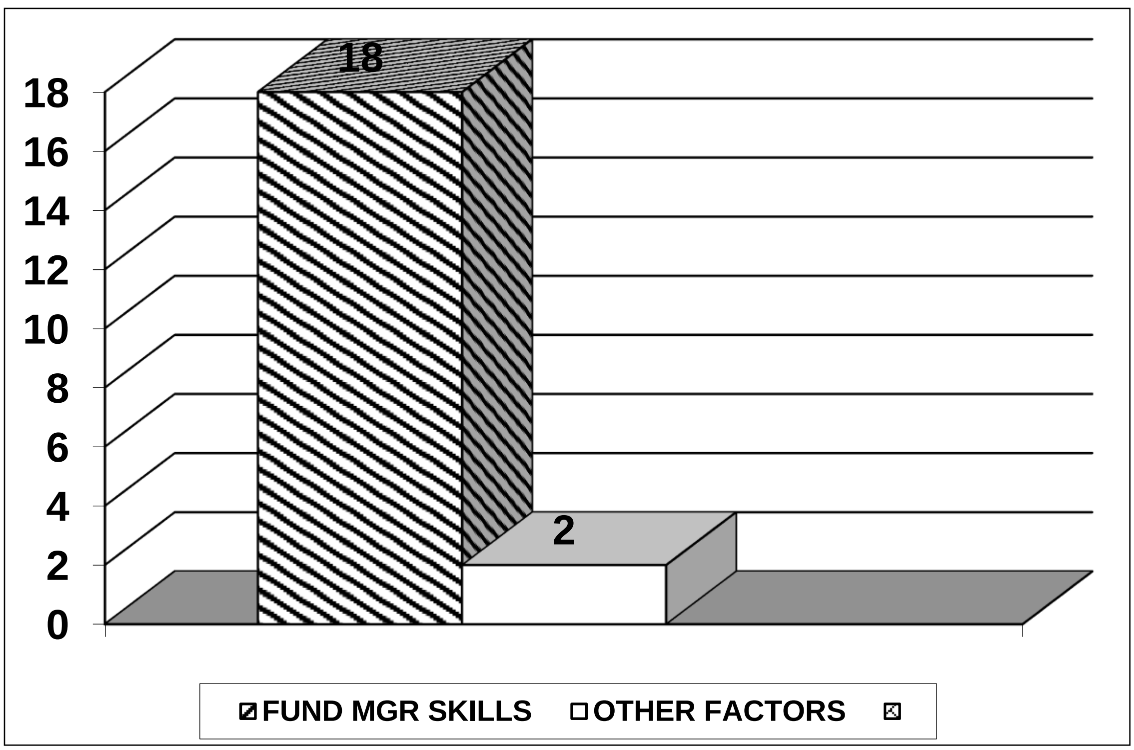


Replying to the question related to the performance of actively managed fund compared to index fund, all of the respondents have replied that yes it is the actively managed fund that can out performed compared to the actively managed fund. In the case of actively managed fund selection of the stocks is in the hand of fund managers so frequency of pick and drop of shares is very high that is how managers utilized their skills to have better return by picking outperforming stocks and dropping those shares which are underperforming.

Question No.4:

What is your opinion about the REASON of outperforming chances of actively managed fund compared to the Index fund?

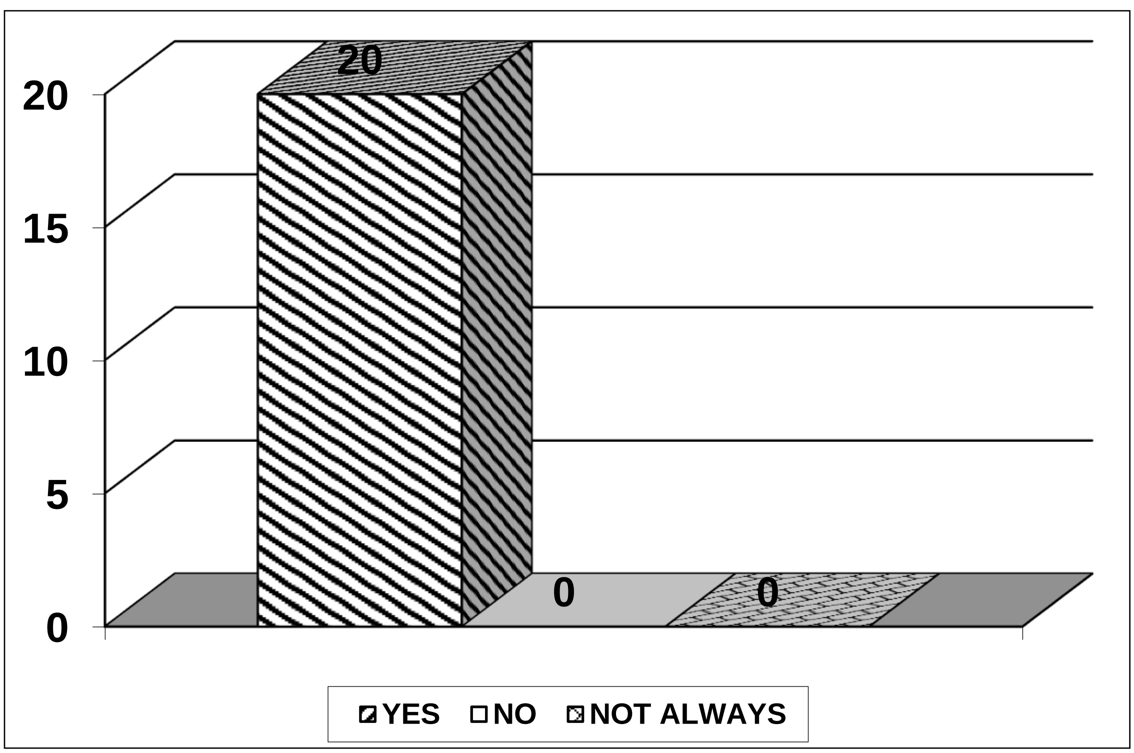
OPTIONS	REPLY	RESPONDENTS	PERCENTAGE
Fund managers skill	18	18	90%
Other factors/by chance	02	02	10%



Replying to the reason of outperforming ability of actively managed fund most of the (90%) respondents are agree that it is the fund managers skill that leads to the better performance of actively managed funds, only some respondents (10%) said that there are other factors as well which determines the performance of the share and so the outperformance of actively managed shares as well.

Question No.5: Are you agree that the reason behind choice of actively managed fund by investors are Probability and expectation of its outperformance chances.

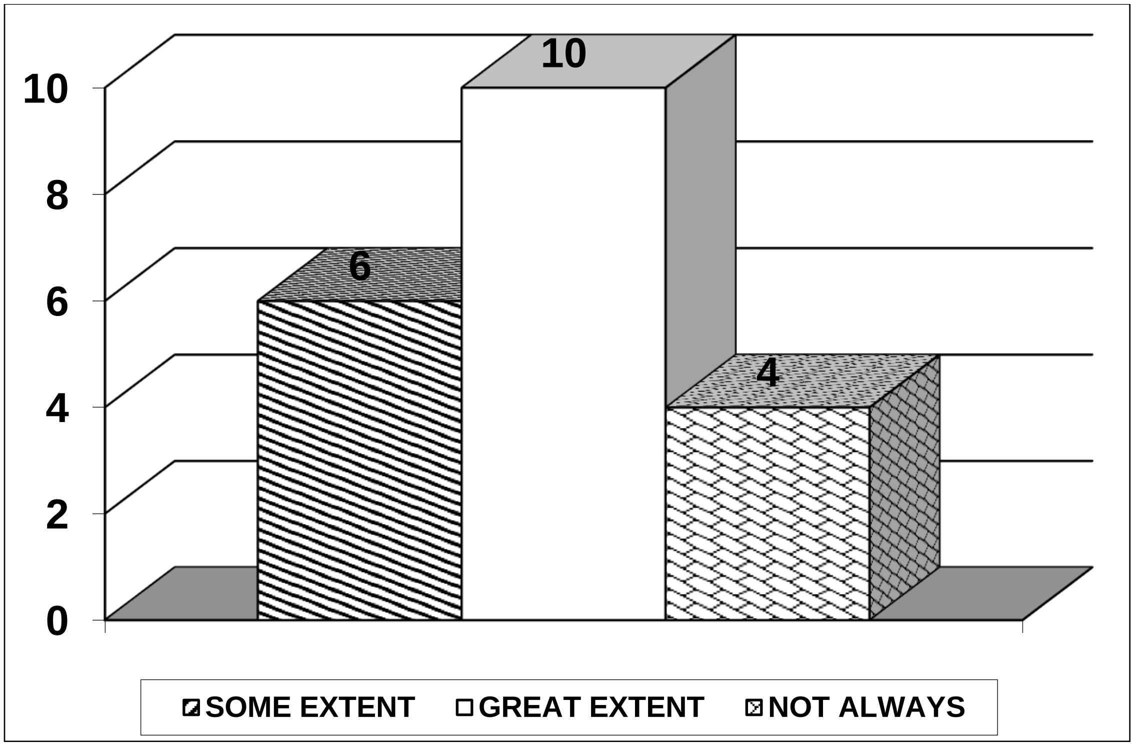
OPTIONS	REPLY	RESPONDENTS	PERCENTAGE
YES	100	100	100%
NO	00	00	00



It is true that investors choose the actively managed fund due to the chances of its out performance. On the other hand investors choose the index fund for safety and return point of view but those investors who choose fund other than index fund they expect the performance of their fund more than the index fund. In the above question all the respondents (100%) have replied that its true that they expect more return-and chances with actively managed fund is to outperform, so they prefer this fund.

Question No.6: Do you believe that share price movement is random and it is based on efficient market hypothesis?

OPTIONS	REPLY	RESPONDENTS	PERCENTAGE
Up to some extent	**06**	**06**	**30%**
Up to great extent	**10**	**10**	**50%**
Not always	**04**	**04**	**20%**

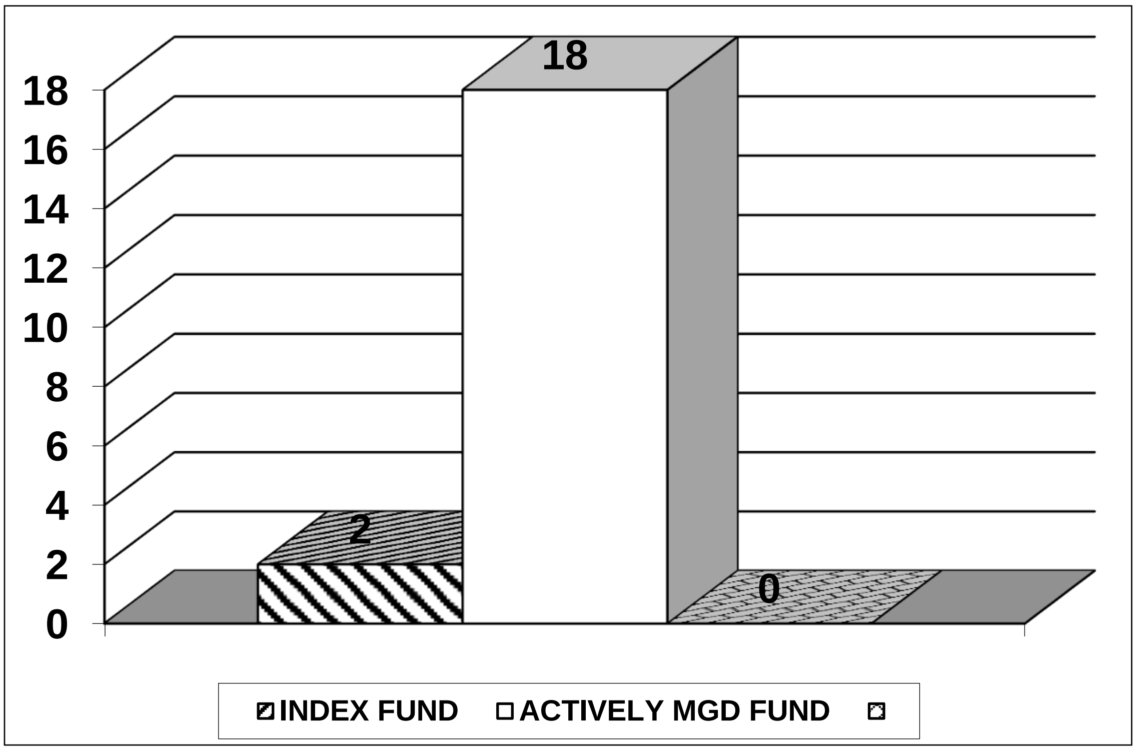


In the above reply 50% respondents are in the favor of efficient market hypothesis. Efficient market hypothesis implies that market information and information about corporate, economy and industry as a whole is readily and continuously available to the investors so it is the information that is updating the investors so market situation can change any time due to the current happening in the economy, industry and company. 20% respondents says that it is not always true that market is efficient. 30% respondents agree that up to some extent efficient market hypothesis is true. So on the average most of the respondents are agree that share price movement is due to efficient market hypothesis that is happens randomly.

Question No.7: What is your opinion about amount of risk investor carries if investment is made in Index fund vs. managed funds- Does Index fund is more risky or Actively managed fund?

OPTIONS	REPLY	RESPONDENTS	PERCENTAGE

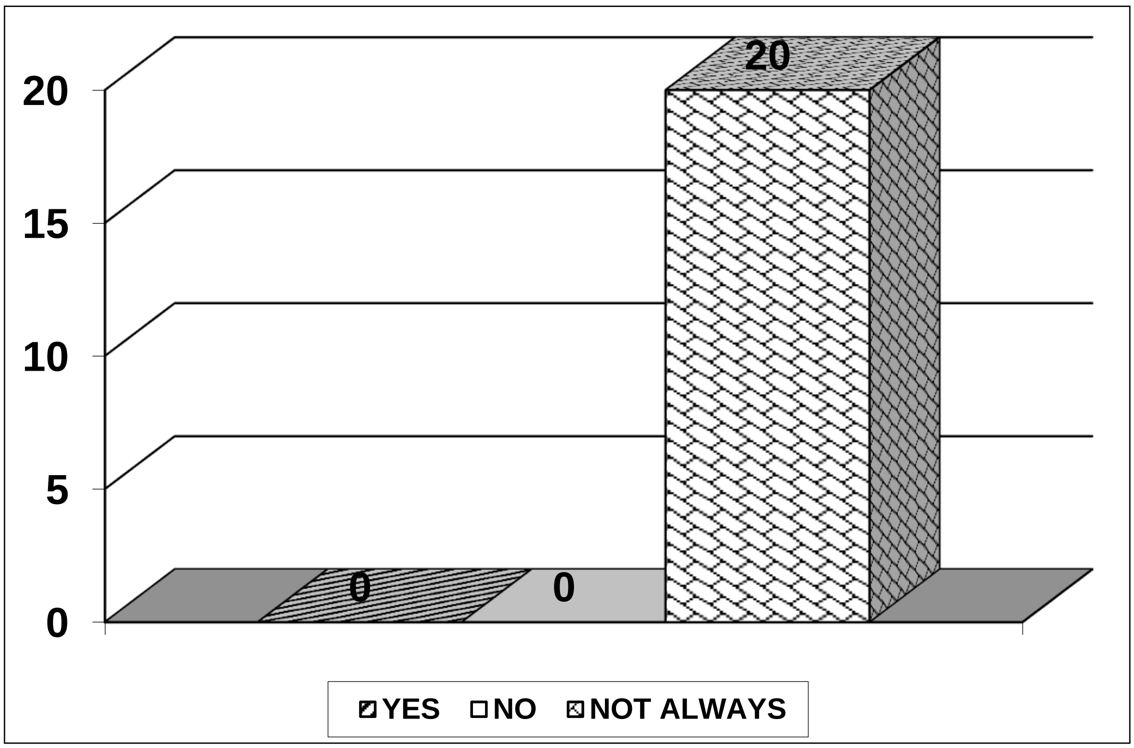
Index fund	02	02	10%
Actively managed fund	18	18	90%



Replying to the riskiness of the index fund vs actively managed fund, most of the respondents (90%) says that actively managed fund is more riskier than the index fund. It seems true that as funds are being managed by the fund manager and there is nothing to do in the case of index fund, as in the index fund return is depending on the index movement and index movement is happens after considering impact of multi industry so risk in the index fund is less and more in the case of actively managed fund.

Question No. 8: Do you think actively managed funds would outperform the Index fund during volatile market situation? Why?

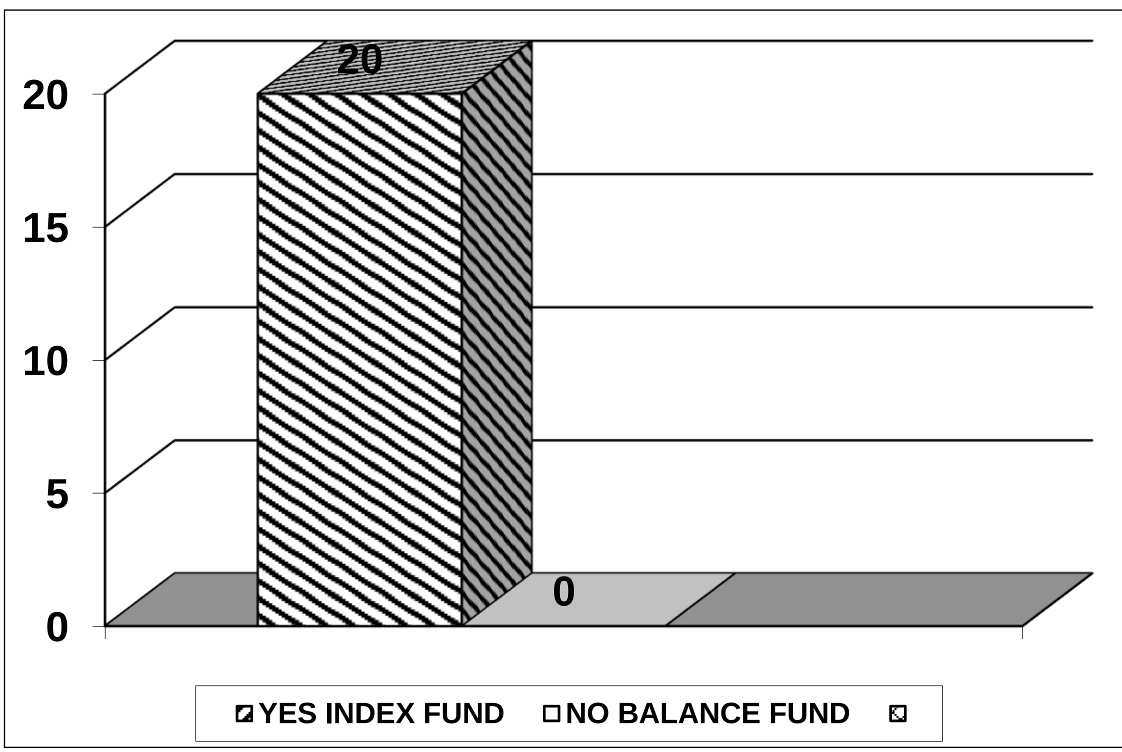
OPTIONS	REPLY	RESPONDENTS	PERCENTAGE
YES	00	00	00
NO	20	20	100%



In the volatility time where average stocks are not stable in this case investment in the actively managed fund is more risky compared to the index fund. Index fund gives safety to the investors as there are no interference from the out site rather performance of picking and dropping of any share is automatically done, rather once stock has been included in the index it will be dropped by the system mechanism automatically. All the shares in the index represents the industry leads the industry so investment in the index fund is safe and in case of the volatility market it is safest place. Investment in the actively managed fund is very risky.

Question No. 9: In your opinion which type of fund would provide comparatively better returns be case of Natural disasters or other calamities or would be affected least?

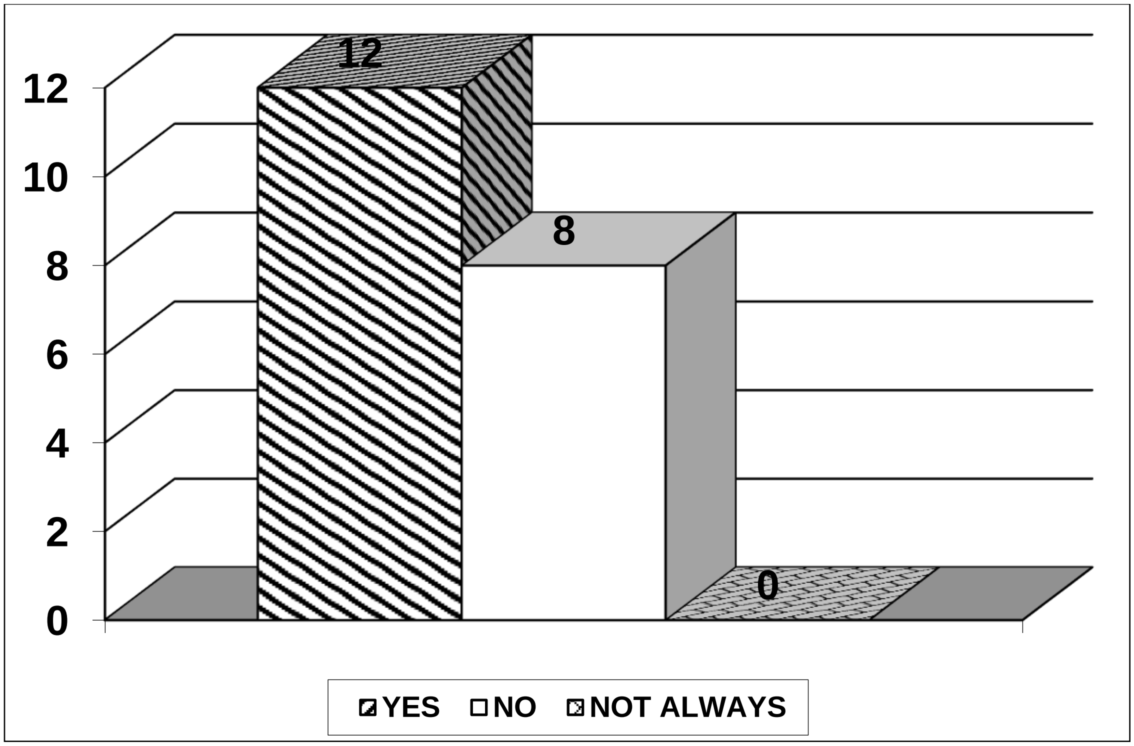
OPTIONS	REPLY	RESPONDENTS	PERCENTAGE
YES Index fund	20	20	100%
NO Balance Fund	00	00	00



This question is similar to the last question of volatility. In this question all the respondents has replied that index fund is better choice in case of natural disaster or other calamities which affects the stock market and that leads to the volatility in the stock prices. All the respondents (100%) says that index fund is more safe than actively managed fund. This is because managing fund by the fund manager would be riskier in the case of natural disaster and other calamities because 100% forecasting is not possible and especially when there is natural disaster and other calamities.

Question No.10: Normally sudden inflow of investments by FII affect positively on Index and an outflow of investment affects negatively. Are you agree?

OPTIONS	REPLY	RESPONDENTS	PERCENTAGE
YES	12	12	60%
NO	08	08	40%



Replying to the question that indicates the correlation between flow of money by FII and performance of index fund, most of the respondents (60%) says that yes there is positive correlation between flow of money by FII and impact on the performance of Index fund. (40%) respondents disagree with the fact. They say it is not correlated to each other. But most of the respondents are in the favor of the fact. Author would like to add that it is the fact that every investor wants their money safe first so prefer to follow the way most of the persons are following. Those who are risk adverse they can choose the unique way. So following the same concept heavy inflow by FII into the Index fund gives an indirect message to the other investors that most of the people / FII or heavy fund has been diverted to the Index fund so there is buying patterns influenced the market and people invest in the Index fund so performance of the fund is also boost up by heavy investment.