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Fintrust

bulletin...

The Economic Survey & Union Budget - An Outlook

The Union Budget showed a clear focus on growth through higher broad based capex push, while getting back on the consolidation path with targetted fiscal deficit.

By Prashant Joshi

The Economic Survey & Union Budget presented for FY 2022-23 highlighted the pro-growth mindset of the government with a focus on supply-side reforms. It aims to provide the impetus for long-term growth sectors and pays attention to digitization, new sunrise growth areas, and startups.

The Budget targets to promote domestic manufacturing, enable broader financial inclusion, ease of doing business, urbanization with a particular focus on overall infrastructure and increased CAPEX. The strong CAPEX push will put pressure on the fiscal deficit, however, will prove beneficial for the economy in the long run and sustain the green shoots of growth that were visible in CY 2021.

In addition to Infra & Capex push, some of the noticeable highlights are:

- Change in customs duty rates, keeping the best interests of the manufacturing sector in focus,
- ECLGS extension till Mar'23, Rs.50,000 crore expansion which is reserved for the hospitality sector
- 100 new cargo terminals to be established under PM Gati Shakti in 3 years
- Issuance of Sovereign Green Bonds green infrastructure, which is in line with India's stated intent at the COP 26
- A rise in allocation to PM Awas Yojana - Rs. 48,000 crores in FY 22-23 from Rs. 27,500 crore in FY 21-22
- Highway network expansion of 25,000 km (Rs.20,000 crores allocated)

On the Direct Tax front:

- In the Budget 2022, the government increased the tax deduction limit in National Pension System (NPS) from 10% to 14% for state government employees. Currently, central government employees can claim a deduction of up to 14% of salary while others are eligible for 10%
- The Centre proposes reducing the Alternate Minimum Tax for Co-Op. societies to 15% from 18.5% earlier
- Taxpayers who have made errors while filing the return (omission of income, etc.) can file updated returns by payment of taxes within two years from the end of the relevant Assesment Year
- Startups established before 31.03.2023 (earlier, it was 31.03.2022; now it will be extended by one year) will be provided tax breaks. Last date for commencement of manufacturing for claiming a lower tax regime of 15% under Section 115 BAB, has been extended by one year to 31.03.2024
- Long term capital gains will be subjected to a surcharge of 15% for all assets against a graded tax tariff. Earlier, this was available only for listed shares and units of mutual funds.
- Rationalization of surcharge - Surcharge on AOPs and long term capital gains is proposed to be capped at 15%.

On the Indirect Tax front:

- The government has proposed changes in customs duties and has impacted many of them positively with few misses
- Also, for the FY 22-23, the subsidy bill (Food, Fertilizer and fuel) has seen a downtrend in allocation
- The government was rational with the divestment appetite and with revenue targets.
- A significant move was to bring cryptocurrencies and non-fungible tokens (NFTs) under the tax net.

The Budget was silent on the personal taxation and sin tax on tobacco. However, the majority of market concerns have been addressed.

The various announcement made in the Budget bodes well for banks, auto, capital goods, infrastructure, housing and housing finance, transport, agriculture, Cement and building materials, health care and pharma, logistics, hospitality and solar power. However, for some sectors, like Coal & Thermal and Steel, the budget was subdued.

Multiple pro-growth measures across sectors, and supply-side reforms augers well for the equity markets. We expect the flows to continue; however one will watch out for U.S. Fed Reserve's rate hike trajectory.

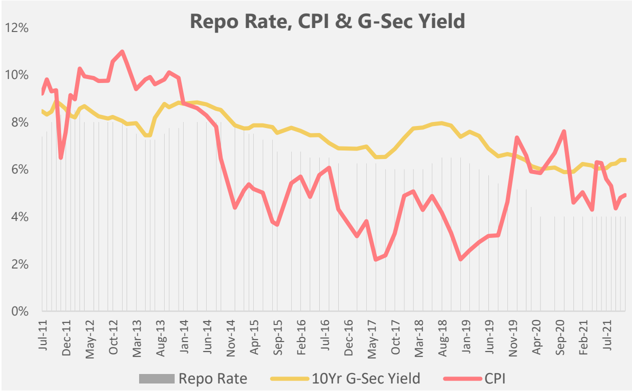
For the fixed income markets, one has to prepare for volatility due to the higher borrowing in the first half of FY 22-23 and expect normalization of monetary stimulus & interest rate rise. Therefore, it merits having exposure toward the short duration instruments and makes a case for floating-rate instruments. Overall, we believe that it is a good, financially prudent, and well-balanced budget.

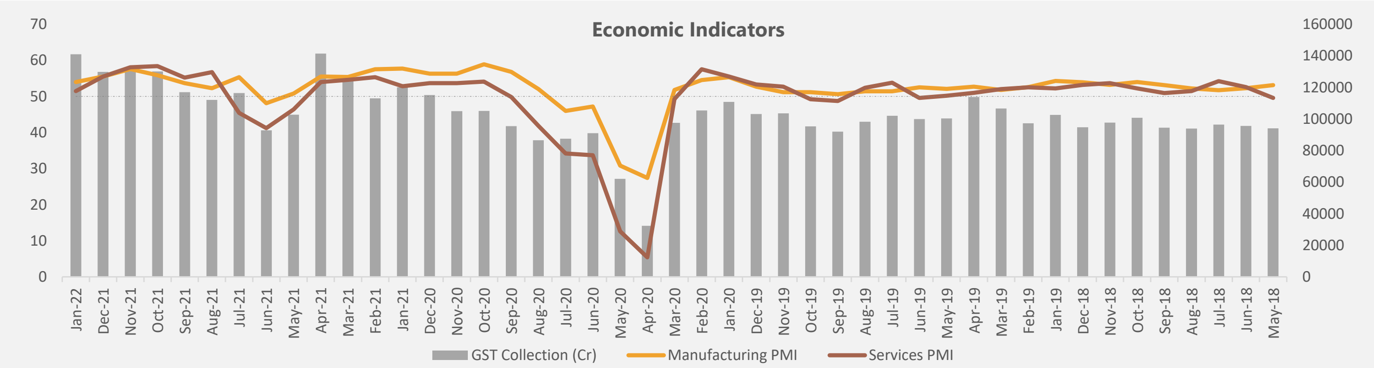
Economic Indicators

- The seasonally adjusted IHS Markit India Manufacturing Purchasing Managers' Index (PMI) was at 54.0 in January, down from 55.5 in December, signalling the weakest improvement in the sector's health since last September. The headline figure remained above its long-run average of 53.6.
- Operating conditions across the manufacturing industry improved at the start of the year, although the new COVID-19 wave restricted growth.
- Data showed the slowest increase in new orders and output in four months, but rate of expansion remained historically elevated. Similarly, there was a substantial, albeit softer, up-turn in input buying.
- India's services sector activity continued to expand in January 2022, albeit at a much slower rate than the previous month, as the sector's Purchasing Managers' Index (PMI) fell to a six-month low of 51.5 from 55.5 in December 2021.
- The escalation of the pandemic and reintroduction of curfews had a detrimental impact on growth across the services sector. Both new business and output rose at rates that were weakest in the last six months.
- Higher food, fuel, material, staff and transportation costs were noted during January. Also, the prices charged for services in India continued to increase at the start of the year, with many companies suggesting that additional cost burdens were transferred to consumers.
- In January, India clocked its highest ever gross Goods and Service Tax collections at Rs.1.41 lakh crore, compared with Rs.1.29 lakh crore in December, driven by improved compliances and proactive recoveries.
- The Union Budget showed a clear focus on growth through higher broad-based Capex push while getting back on the consolidation path with an estimated fiscal target of 6.9%/6.4% of GDP for FY22/FY23.
- The budget estimates seem realistic and transparent with no off-budget expenses.

Head's Up from the Central Bank

- The RBI, in its bulletin for January 2022, said India's overall economic activity remains strong, driven by upbeat consumer confidence and an uptick in bank credit and, most importantly, on expectations that Omicron may turn out to be a flash flood rather than a wave, have further brightened the prospects.
- The RBI's digital-payments index came in at 304.06 during September 2021, compared with 270.59 in March 2021 and 217.74 in September 2020.
- According to RBI data, bank credit rose 9.16% to Rs 116.83 lakh crore, and deposits rose 10.28% to Rs 162.41 lakh crore for the fortnight ended December 31, 2021.





Debt Market & Other Indicators

- The interbank call money rate settled at 3.25% as of 28th January, compared with 3.15% a month earlier. Yields throughout the maturity had gone up in January.
- The yield on the 10-year benchmark 6.10% 2031 paper settled at 6.78% on 28th January compared with 6.46% a month earlier. Bond prices remained under pressure throughout the week on tracking a rise in US treasury yields amid expectations that US Fed may start hiking key rates from March 2022.
- Fixed Income markets were keenly watching the fiscal deficit target for FY23. Traders were disappointed that the fiscal deficit target for FY 22 is being revised upward to 6.9% despite higher than budgeted revenue collection.
- The rupee ended lower at 74.54 against the US dollar after the banks continued to sell dollars on behalf of exporters and FIIs who are continuously selling Indian equities.
- WTI Crude rebounded sharply in January to $88, from $77 in December per barrel due to supply concerns surrounding the Russia-Ukraine tensions & fading concerns about omicron's impact on economic growth.
- Bullion prices went down along with demand for hedging as concerns about omicron's impact on economic growth faded slowly.

Indicator	Jan 22	Dec 21	Trend
Call rate	3.25%	3.15%	▲
3Month CP	4.20%	4.35%	▼
1Year CP	5.00%	4.91%	▲
3Year AAA	5.73%	5.60%	▲
5Year AAA	6.35%	6.20%	▲
10Year G-Sec	6.78%	6.46%	▲

As on 3rd December 2021

Currency (USD)	Jan 22	Dec 21	Trend
US Dollar	74.54	74.33	▲
GBP	100.20	100.44	▼
EURO	83.72	84.21	▼
YEN	0.65	0.65	▲

Commodity (USD)	Jan 22	Dec 21	Trend
WTI Crude	88.15	76.99	▲
Gold	1795.00	1815.87	▼
Silver	22.39	23.35	▼

Debt Market Outlook

- Globally, markets and central banks will look closely at the rate at which the interest rate is hiked, and US Fed withdraws stimulus as inflationary pressure mounts.
- It is advisable to stay at the shorter end of the yield curve. Investors may look at low duration and similar short tenure debt categories for their debt allocations.

Domestic Equity Market

- Indian equities snapped four-week gains on persistent inflationary concerns and fears about a sooner-than-expected rate hike by the US Federal Reserve (Fed) in the policy meeting this week. S&P BSE Sensex and Nifty 50 closed flat with marginal loss. Broader indices, NSE Midcap & BSE Smallcap closed lower by 0.6% & 0.8% respectively.
- Most sectors ended negatively with information technology (IT), healthcare, and consumer durables declining the most. S&P BSE IT, S&P BSE Healthcare and S&P BSE Consumer Durables declined 8.2%, 8.0% and 6.4%, respectively.
- FIIs remained negative for the Indian markets for the fourth consecutive month, with a total sale of Rs.1,85,243 in the cash segment of the equity market for the fiscal year 2021-22.
- Further, the increasing number of daily cases of Covid-19 domestically, persistent foreign institutional investor (FII) selling, and soaring oil prices also weighed on the investor sentiment.
- The International Monetary Fund (IMF) trimmed India's growth forecast for fiscal 2022 to 9% from the earlier 9.5% over concerns surrounding the impact of the spread of new Covid-19 variants on business activity and mobility.
- The budget focused on clean energy and advanced technologies, as seen with
    - incentives for Solar PLI and EV ecosystem,
    - infrastructure status for data centres,
    - plan to introduce Central Bank digital currency and
    - taxation on virtual digital assets.

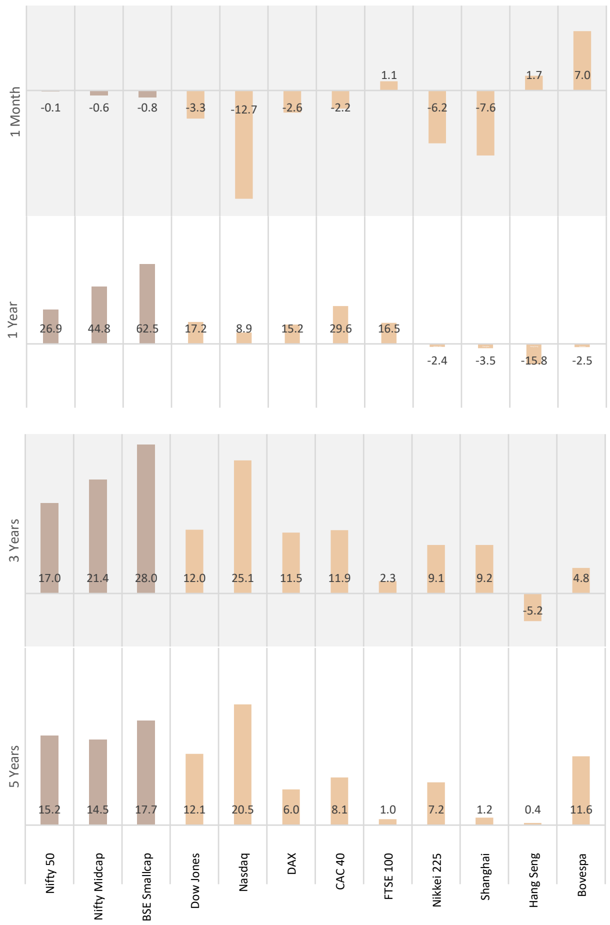
Broad Indices	Jan 22	Dec 21	Change
Nifty 50	17340	17354	-0.1%
BSE Sensex	58014	58254	-0.4%
Nifty Midcap	30274	30443	-0.6%
BSE Smallcap	29227	29458	-0.8%
S&P BSE 500	23715	23811	-0.4%

Sectoral Indices	Jan 22	Dec 21	Change
S&P BSE Bankex	43569	40409	7.8%
S&P BSE Metal	18985	19246	-1.4%
S&P BSE Healthcare	24104	26206	-8.0%
S&P BSE IT	34736	37844	-8.2%
S&P BSE FMCG	13461	13785	-2.4%
S&P BSE CD	41919	44768	-6.4%
S&P BSE Auto	26408	24818	6.4%
S&P BSE Oil & Gas	18672	17508	6.6%
S&P BSE Realty	3812	3841	-0.8%
S&P BSE CG	29158	28751	1.4%
S&P BSE Power	3937	3482	13.1%

Global Equity Markets

- This week, global equities mostly ended lower after the Fed signalled a rate hike in March. As a result, the US treasury prices also declined.
- For January, US stocks plunged sharply, with Dow Jones & Nasdaq falling 3.3% and 12.7%, respectively. Geopolitical tensions between Ukraine & Russia and mixed earnings reports also kept the markets under pressure.
- US Markit Flash Manufacturing PMI fell to 55.0 in January from 57.7 in December, while the Services PMI dropped to 50.9 in January from 57.6 in December.
- US GDP rose 6.9% on-year in the fourth quarter compared with a 2.3% growth in the third quarter. The US economy grew 5.7% in 2021, the strongest since 1984, compared with a 3.4% contraction in 2020.
- After the Fed signalled an interest rate hike in March, Britain's FTSE rose 1.08% following gains in banking stocks. Other European equities ended lower, with France's CAC 40 falling 2.2% and Germany's DAX dropping 2.6%.
- UK consumer price index (CPI)-based inflation rose 5.4% y-o-y in December, compared to a 5.1% rise in November. Eurozone consumer prices rose 5% y-o-y in December, up from 4.9% in November.
- Asian equities also showed a similar trend, with Japan's Nikkei and China's Shanghai Composite falling 6.2% and 7.6%, respectively. Hongkong's Hang Seng ended with a 1.7% gain.
- The BoJ kept its key short-term interest rate unchanged at -0.1%. It revised up its inflation forecast for the year beginning in April to 1.1% from the earlier estimate of 0.9%
- China's economy grew 4% y-o-y in the fourth quarter compared with 4.9% growth in the third quarter. The economy grew 8.1% in 2021 compared to a revised 2.2% growth in 2020.
- China's industrial profits grew 4.2% on-year in December, sliding from November's 9% growth.
- The People's Bank of China slashed the one-year loan prime rate (LPR) by 10 bps to 3.7% and the five-year LPR by 5 bps to 4.60%.

Performance of Indian & Global Indices



Note: *For Periods till 1 year the returns are absolute and for beyond 1 year, its CAGR returns*

Equity Market Outlook

- According to Buffet Indicator, the ratio of total market cap over GDP is currently at 102.2%, which indicates the stock market is modestly overvalued (Recent 10 Year Maximum - 117.03%; Recent 10 Year Minimum - 54.47%; Recent 10 years mean - 79.48%). We continue to remain cautious and constructive on equities and believe India is on the cusp of achieving robust growth over the next few years. Higher Capex provisioning should potentially revive overall capital expenditure across the sectors, boost employment and credit growth.
- We would advise investors not to time the market and invest in a disciplined way in equities for the long-term within their earmarked asset allocation (based on one's risk profile). In the current market scenario, staggered investments through SIPs or STPs would remain one of the best ways to invest in equities.

Passive Or Active Funds: What's The Good Choice?

In the last few years we have been witnessing exponential rise in assets under management of passively managed funds. These have outstripped growth in actively managed funds. Even in terms of inflows, passively managed funds have seen better inflows than actively managed counterparts. The report compares the two to know which is better.

Quotes By Prashant Joshi
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There is a massive shift that is happening globally in the investment world. Since 2008, investors are now moving towards passive investment strategies. Worldwide, after the great financial crisis many investors both at the retail level as well as at the institutional level have started shifting their investments from relatively expensive actively managed mutual funds to relatively cheap index mutual funds and exchange traded funds (ETFs), which together come under the term passive index funds. ETFs and index mutual funds are technically different, but they share the fundamental feature that both seek to replicate existing stock indices while minimising expense ratios.

In contrast, active funds employ fund managers who strive to buy stocks that will outperform, which leads to higher expense ratios. Between 2009 and 2020, passively managed funds have witnessed their asset under management (AUM) increasing from USD 6 trillion to USD 22 trillion, showing an annual growth of 13 per cent compared to 10 per cent overall growth witnessed by the mutual fund industry. Passive products recorded their highest growth in the pandemic-affected year. Passive AUM rose by 17 per cent globally during 2020 with strong net inflows and market growth. India has not remained immune to this tectonic shift.

In the last few years we have been witnessing exponential rise in AUM of passively managed funds. These have outstripped growth in actively managed funds. Even in terms of inflows, passively managed funds have seen better inflows than actively managed counterparts. Since the start of March 2020, passively managed funds, including ETFs and index funds, have seen a cumulative inflow of Rs 1.04 lakh crore. Comparatively, actively managed funds in the same period were able to garner little less than half of that at Rs 0.5 lakh crore.

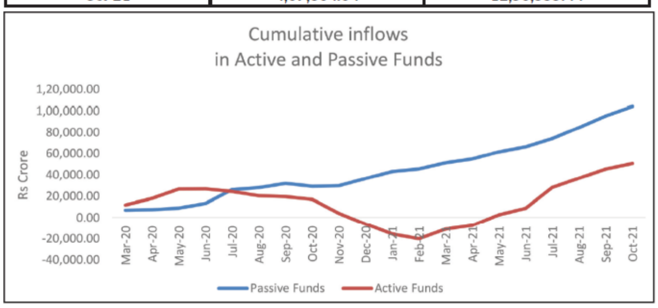
If we look at the monthly inflows we find that out of the last 20 months ending October 2021, in eight months between July 2020 and February 2021 actively managed equity funds saw a continuous net outflow. Whereas in the case of passively managed funds we saw that only in the month of October 2021 was there some net outflow. The AUM of the passively managed funds in the last 20 months has increased by 263% compared to 224% of actively managed equity funds. They are now 31.5% of the total equity-based mutual fund AUM compared to 26.5% at the start of the pandemic.

Growing Clout of Passively Managed Funds

The rise of passively managed assets in developed markets such as the US was mainly due to the underperformance of active funds compared to their respective benchmarks, the lower cost of passive funds measured through expense ratio as compared to active funds, and the change in regulations and policies that favoured passive investments. The same reasons stand true for Indian investors who are driven to embrace passively managed funds such as index funds and plain vanilla ETFs.

According to S and P Indices versus Active Funds (SPIVA) scorecard for India for the period ending June 30, 2021, over 80 per cent of the funds in the equity large-cap category have underperformed the benchmark over one, three and five-year periods. For a ten-year period, almost 66 per cent of the large-cap funds have underperformed their benchmark. The SPIVA India scorecard compares the performance of actively managed Indian mutual funds with their respective benchmark indices over one, three, five and ten-year investment horizons.

Months	AUM (₹ Cr.)	
	Passive Funds	Active Funds
Mar-20	1,54,551.69	5,78,507.69
Apr-20	1,74,003.12	6,60,070.27
May-20	1,70,609.82	2,90,256.60
Jun-20	1,86,508.87	7,01,016.04
Jul-20	2,10,551.41	7,37,608.12
Aug-20	2,19,002.12	7,69,115.16
Sep-20	2,17,816.34	7,64,309.50
Oct-20	2,23,348.47	7,77,292.19
Nov-20	2,47,969.86	8,57,510.40
Dec-20	2,71,496.33	9,06,766.98
Jan-21	2,72,130.76	8,91,399.41
Feb-21	2,90,752.78	9,63,358.24
Mar-21	2,95,094.99	9,79,367.20
Apr-21	2,97,996.86	9,91,362.64
May-21	3,22,569.44	10,67,899.26
Jun-21	3,31,265.73	11,10,025.49
Jul-21	3,40,392.75	4,11,901.60
Aug-21	3,74,342.87	12,33,142.23
Sep-21	3,96,761.17	12,79,647.20
Oct-21	4,07,864.04	12,96,559.44



The following table depicts that how many funds within the category underperformed the benchmark in 1-year, 3-year, 5-year and 10-year:

Fund Category	Comparison Index	1-Year (%)	3-Year (%)	5-Year (%)	10-Year (%)
Indian Equity Large-Cap	S&P BSE 100	86.21	86.67	82.72	65.93
Indian ELSS	S&P BSE 200	53.66	76.19	76.19	48.57
Indian Equity Mid-/ Small-Cap	S&P BSE 400 MidSmallCap Index	57.14	48.65	69.57	40.3
Indian Government Bond	S&P BSE India Government Bond Index	70.83	51.85	71.43	86
Indian Composite Bond	S&P BSE India Bond Index	50	97.9	97.87	100
Source: S&P Dow Jones Indices LLC, Morningstar, and Association of Mutual Funds in India. Data as of June 30, 2021. Returns are shown in Rs.					

The table shows the comparison of the performance of different fund categories with respect to their benchmarks. It clearly shows that in the last one year all the equity-based funds have underperformed their benchmarks. The worst underperformance comes from large-cap funds in the last three-year period. On the surface, it looks that actively managed funds are not able to outperform their benchmarks in different time periods – which we will explain why this can be misleading – and hence investors are moving towards passively managed funds.

The second reason why passively managed funds are being widely accepted is due to their low cost structure. Passively managed funds by their construct have lower expense ratio. To manage a passively managed fund, asset management does not need a high paying research analyst or need a frequent churning to generate alpha – all of this goes into savings for passively managed funds and ultimately towards the returns of the fund. So every rupee saved will add to the returns of the fund. In case of actively managed funds, a fund manager is supported by analysts and a research team to carry out research and track the performance of the companies in which investment is being made.

Since the people involved in the process are well-paid, it adds to the cost of the fund management, leading to comparatively higher expense ratios of actively managed funds. Our study of expense ratio for the large-cap dedicated funds shows that index funds and ETFs have much lower expense ratio that helps them to perform better in the long run. It is a well-established fact that expense ratio remains one of the few factors that have a definite impact on the future performance of the funds.

Category	Expense Ratio (%)*
Index Regular	0.68
Index Direct	0.48
Actively Managed Funds Regular	2.09
Actively Managed Funds Direct	0.97
*expense ratio of Large Cap funds at the end of October 2021.	

The table above shows that the difference in expense ratio between a regular index fund and actively managed fund is more than 1.4 per cent. This difference may seem insignificant, but over a long period these costs add up. The cost of funds is considered a significant factor in value creation over the long term. For example, if you invest Rs 5,00,000 in a fund that has an expense ratio of 2.1 per cent per annum, then it means that you need to pay Rs 10,500 per year to the fund to manage your money. Also, if the fund returns equal 20 per cent and has an expense ratio of 2.1 per cent, you would get a return equal to 15.9 per cent. The net asset value (NAV) of a fund is reported after deducting all fees and expenses.

The next big factor that is favouring the rise of index funds or ETFs is government policies and the beneficial regulatory environment that promotes passively managed funds. First, in 2017, Securities and Exchange Board of India (SEBI) came out with the re-categorisation and rationalisation of mutual fund schemes, according to which fund houses are required to manage only one product offering in each style category and also the investment universe. Earlier, a large-cap dedicated fund would have invested only 50 per cent of its net assets into large-cap stocks and rest into mid-cap and small-cap stocks still benchmarked to a large-cap index. This would make large-cap funds' performance better than their benchmarks in the long run assuming that the broader market stock performs better than the large-cap stocks.

Now with rationalisation and categorisation such inconsistencies have been weeded out and apples are being compared to apples. This has enhanced transparency since investors can easily compare the performance of fund offerings in each style category. At the same time, it has made it difficult for large-cap funds to show outperformance. SEBI also mandated that fund managers should benchmark the performance of equity funds against total return indices (TRI) and not the price return index (PRI). This was done in order to emphasise the importance of dividend payments in addition to capital appreciation when evaluating portfolio returns.

Assuming dividend yield of 1.5 per cent, it increased the threshold level for a fund manager by similar percentage to outperform their benchmarks. This has also helped passive investment strategies as now even a lower number of funds can show outperformance. Besides, the government launched disinvestment drives through ETFs. This announcement helped create large awareness and interest in ETFs. In 2015 it even allowed Employees' Provident Fund Organisation (EFPO) to invest in equities through large-cap ETFs. The total EPFO allocation in ETFs was Rs 1.03 lakh crore as of March 31, 2020.

Caveat Emptor

The report by SPIVA is quite comprehensive in its coverage; however, it represents a single point of comparison out of many such possible points. Hence we decided to check the performance of the funds and their outperformance or underperformance compared to the benchmarks on a rolling basis. This will give us good enough points to come to a proper conclusion. For our analysis we took the average returns of the funds on a daily basis and converted them into rolling three-year and five-year returns. Similarly, we did this for their respective benchmarks. We did this exercise for large-cap-dedicated funds and mid-cap-dedicated funds and took the regular plan with a longer history.

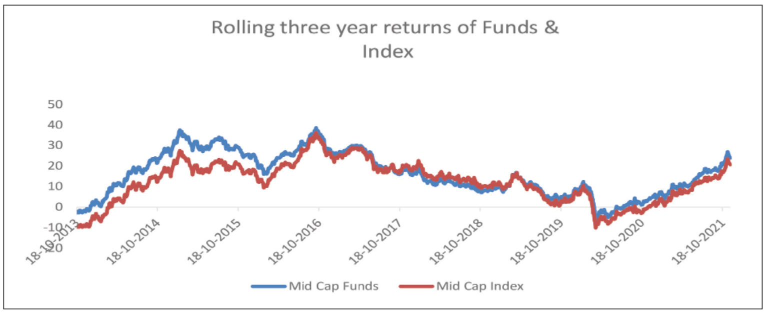
Following this exercise an entirely different picture appeared in terms of the average performance of funds with respect to their benchmarks. Large-cap-dedicated funds have appeared to perform better than their benchmarks most of the times both in a three-year and five-year timeframe. For example, out of the total 2018 instances in large-cap-dedicated funds there were only 337 instances when the funds' average return was worse than the index return. What seems to be quite clear is that the outperformance of the large-caps fund has been in a declining mode in the recent period. The rolling return graph of the funds against their benchmarks reflects the same.

Nevertheless, in case of mid-cap-dedicated funds in a longer period of five years, we did not see any single period of underperformance by them. Nevertheless, in a three-year period there were some instances of underperformance by the funds. The reason why mid-cap-dedicated funds on an average do better than their benchmarks is because of information asymmetry that still exists in this category. As compared large-cap stocks, there is very less information asymmetry and they are well-researched so that a fund manager has little chance to generate alpha. Hence, where there is inefficiency in the market, it gives opportunities to fund managers to identify investment opportunities and generate superior returns, resulting in a higher preference for actively managed funds versus passive funds.

Passive versus Active

Now the moot question for an investor is whether he should adopt a passive or active strategy to build his portfolio. According to Prashant Joshi, Co-Founder and Partner, Fintrust Advisors LLP, "Given the Indian context, there is no strait-jacket answer to it. In the large-cap space, one can allocate up to 40-60 per cent towards passively managed funds."

The reason for such allocation, as he puts it, is, "Till 2015 many actively managed funds were outperforming passively managed funds; however, the table has turned since then as a handful of funds have consistently been able to do so. Since the expense ratio of the passively managed funds is significantly lesser than the actively managed funds, a more significant allocation can be justified." Nevertheless, in the case of mid-cap and small-cap funds, Joshi is of the opinion that "many of the funds are consistently outperforming the passive funds."



However, a few deliver significant alpha over more extended timeframes of three and five years. As a result, it may make sense to veer away from passively managed funds and rely more on an active investing style as there is a huge room for alpha creation in the mid and small-cap space. We believe that the Indian equity market and investor are yet to mature as a developed market and till that time actively managed funds especially dedicated to the broader market still stand a good chance to generate better returns than their benchmarks. Therefore, we suggest building a portfolio which is mix of both actively and passively managed funds. Beginners would do well to to mark large-cap allocation towards index funds and well-managed active funds.

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