Are you tracking closely?

Index Fund vs. ETF | Tracking Difference | Tracking Error

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04th Feb 2023

This is the question an investor needs to ask the Fund House(s) if she is investing in passive funds. We have witnessed higher investment in passive funds, especially Large Cap focused funds (however, fund flows into passive large cap funds need to be seen in the context of increasing contribution of EPFO which accounts for at least 2/3rd of inflows).

For a passive strategy/fund, 'Tracking Difference' and 'Tracking Error' are more important metrics to follow than any other parameter. Both parameters measure how closely the strategy has managed to track the performances of the underlying index. Lower the 'Tracking Error'/'Tracking Difference', better the performance tracking ability of the fund.

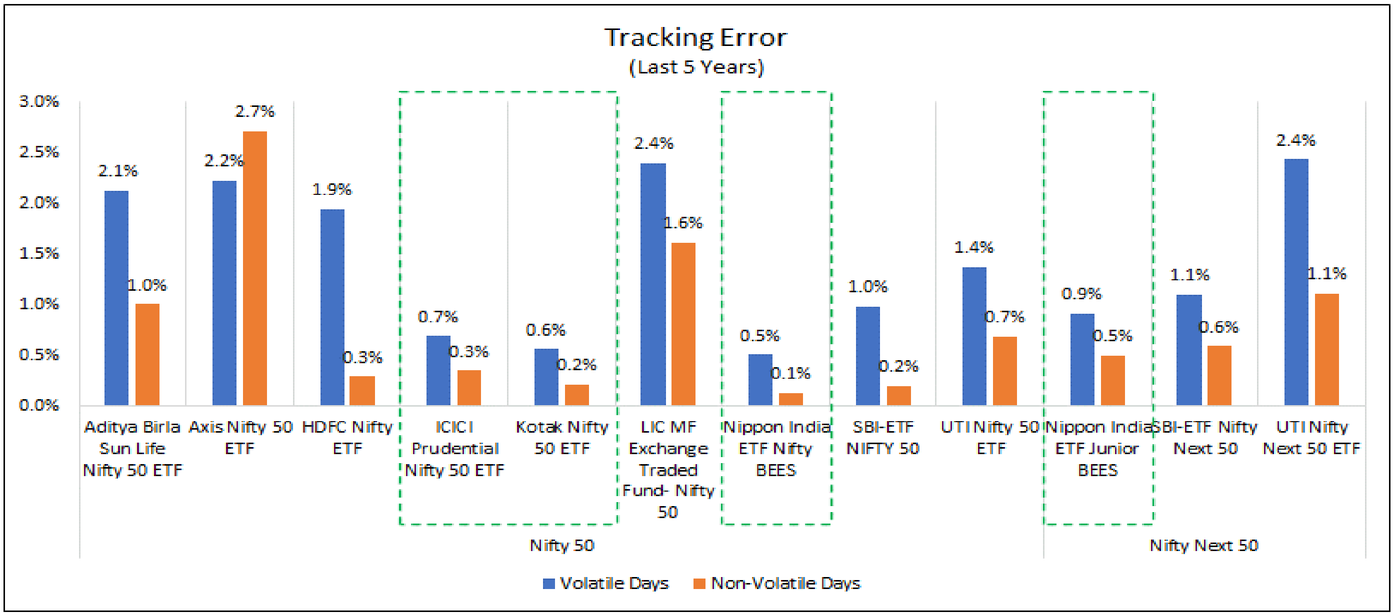
Tracking Difference = Passive Fund Return – Underlying Index Return

Tracking Error = Standard Deviation of 'Tracking Difference'

An investor has two alternatives for investing in such passive strategies – Index Funds or Exchange Traded Funds (ETFs). The main difference between the two is that units of an Index Fund can be bought directly from the Fund House at day end NAV whereas, in the case of ETFs, an investor can either buy it from the Fund House at day end NAV (subject to new SEBI regulation limit, covered subsequently) or purchase it on an exchange at any time during the day at prevailing market prices (like any other equity share).

So, the next logical question is what an investor should prefer. In terms of cost (Expense Ratio), ETFs are cheaper than Index Funds (even after accounting for transaction costs that investors will have to bear if ETF units are bought on exchanges). However, an important point of distinction is the liquidity of ETFs on exchanges and thus, the resultant impact cost.

In India, there is limited liquidity of ETF units on exchanges which means the quoted price of ETFs can differ significantly from their underlying NAVs. On the days when markets are volatile, we have observed that ETF prices differ considerably from the underlying NAVs. We can check the chart below which compares the 'Tracking Error' of ETFs on 'Volatile' and 'Non-Volatile' days:



In the chart above, 'Volatile' days mean the days on which the index moved by 1% or more either way. Only select ETFs (highlighted in the chart) have tracking error below 1% on both 'Volatile' as well as 'Non-Volatile' days. Some ETFs have higher tracking error even on 'Non-Volatile' days.

Tracking Error of ETFs becomes an even more important factor after the new SEBI circular which limits the purchase or redemption of ETF units directly from fund houses. As per the new circular dated May 2022, only orders (purchase or redemption) worth INR 25 cr. or more can be directly routed through Fund Houses. All other orders are to be executed on exchanges.

The circular intends to improve the liquidity of ETF units on exchanges. However, in the last week of Jan 2023 when markets were volatile, we could still observe high tracking difference in the case of many ETFs:

Passive Large ETF	Tracking Difference (23 Jan to 1 Feb 2023)		
	Avg	Min	Max
Nifty 50 ETF			
Aditya Birla Sun Life Nifty 50 ETF	0.01%	-1.10%	0.96%
LIC MF Exchange Traded Fund- Nifty 50	0.27%	-0.54%	1.77%
HDFC Nifty ETF	-0.05%	-0.63%	0.45%
ICICI Prudential Nifty 50 ETF	0.00%	-0.21%	0.19%
Kotak Nifty 50 ETF	0.01%	-0.40%	0.31%
LIC MF Exchange Traded Fund- Nifty 50	-0.05%	-0.53%	0.30%
MIRAE ASSET NIFTY 50 ETF (MAN50ETF)	-0.02%	-0.29%	0.17%
Nippon India ETF Nifty BEES	0.01%	-0.12%	0.10%
SBI-ETF NIFTY 50	0.01%	-0.16%	0.15%
Tata Nifty Exchange Traded Fund	-0.16%	-1.55%	1.69%
UTI Nifty 50 ETF	0.19%	-0.25%	0.97%
Nifty Next 50 ETF			
ICICI Prudential Nifty Next 50 ETF	0.02%	-2.96%	2.94%
Nippon India ETF Junior BEES	0.01%	-0.13%	0.11%
SBI-ETF Nifty Next 50	0.20%	-3.59%	3.64%
UTI Nifty Next 50 ETF	0.13%	-5.81%	7.68%

To conclude, even though ETFs provide an option of redeeming or buying units on exchanges at any time during the day, a lack of liquidity on exchanges can result in high impact costs. Thus, we would prefer Index Funds over ETFs for ‘passive exposures’ till the time there is an improvement in ETF liquidity.

Rational Investing, Happy Investing!

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