Speaking Notes of Shri Amarjeet Singh, WTM, SEBI at the Cafemutual Passives Conference, 2025

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1. Good morning. It is a pleasure to be part of this event. I thank Cafemutual for inviting me.

2. I commend the organizers for their continued efforts in hosting the annual Passive Investing Conference. Passive investing has grown in relevance over the years, both in India and globally, as investors increasingly seek low-cost, transparent, and diversified investment options. These forums are therefore, invaluable for exchanging ideas, and for shaping the future of our industry.

3. In my remarks today, I would like to focus on three broad aspects – i) first, some data and trends pertaining to the passive investing landscape ii) secondly, I would like to touch upon the dynamic between active and passive investing iii) finally, I would like to reflect on some key enablers that are essential for orderly growth of the industry, particularly the passive segment.

A. Key Trends

Rise of passive investing

4. The roots of passive investing go back to the 1970s, when John Bogle founded Vanguard and launched the first index mutual fund. At the time, the concept was ridiculed and critics dubbed it “Bogle’s folly.”

5. Fast forward 50 years, and that “folly” now manages trillions of dollars. In the US, passive funds surpassed active funds in assets under management in 2023. According to data published by the Investment Company Institute, as on April 30, 2025, over 58% of U.S. equity fund assets are now in passive strategies.

6. While India’s passive investing journey began in the early 2000s, passive funds have gained more traction in the past 5 years. To share some data points -

- The share of passive funds (index funds and ETFs) has increased from 6.5% to over 17% in the past 5 years. The AUM of passive schemes (ETFs and Index Funds) as on March 31, 2025 was over INR 11.2 lakh crore (INR 11.2 trillion).
- Within the passive fund ecosystem, ETFs account for 75% of the AUM. A significant portion of the growth in ETFs has been driven by investments made by the EPFO. In the past couple of years, both ETFs and Index funds have grown at a CAGR of over 28%.
- The number of passive schemes have also grown. As on March end 2025, investors had around 561 passive schemes to choose from, an over four-fold increase from 119 in 2020.
- The number of retail folios in passive funds rose approximately 35% from 29.7 million to 40 million in the same period.
- Individual investors (including retail and HNIs) now account for 26% of the total AUM in passive funds, up from just 13%, 5 years ago.

Low cost

7. So, what explains this increasing shift to passive investing. Low cost is undeniably a reason.

8. The cost of passive investing is much lower than active funds. Price wars and competition in the ETF space has further put downward pressure on fund fees across the globe. In the US, competition has driven fees to zero in the case of a handful of index funds and ETFs. In India, the average TER charged for index funds and ETFs is well below the regulatory limits.

9. As the industry grows and competition intensifies, I believe the pressure on fees is only going to increase. This is a welcome trend for investors and one that pushes all asset managers — passive or active — to be more efficient.

Performance

10. In addition to low cost, another driver of the passive investing movement seems to be under-performance of active schemes.

11. As per data published by S&P, in the USA, 85% of large cap funds under-performed the S&P 500 in a 3 year period. Over a 15 year period, this number increases to 90%. Similar trends are seen in various other global markets.

12. In India, for a 3 year return period (as on Feb. 28, 2025), in case of direct plans, 43% of total schemes (by number) comprising 29% of total direct plan AUM under-perform the benchmark. For regular plans, the number increases to 67% of total schemes (by number) comprising 49% of regular plan AUM.

B. Active and Passive approaches

13. With this, let me now turn to the dynamic between active and passive investing approaches.

14. The premise of active management is attractive — that with skill, insight, and timing, one can beat the market. And no doubt, there are funds which have done so. But as the data shows, finding these funds before they outperform is the challenge.

15. On the other hand, the roots of passive investing lie in the Efficient Market Hypothesis (EMH) — the idea that market prices reflect all known information, making it near-impossible to consistently beat the market.

    A related idea is the wisdom of crowds, illustrated by Sir Francis Galton's ox-weight guessing contest in 1906. No individual was able to guess the weight of the ox correctly, but the median guess of 787 people was nearly spot-on. Markets, in many ways, reflect that same collective intelligence.

16. While passive investing has its advantages, concerns have been expressed with respect to its rise. Perhaps, the most important is that the methodology related to index construction and modification should be transparent, and its management should be subject to adequate governance and accountability mechanisms.

17. Additionally, some commentators suggest that since passive investing does not take into account a company's fundamentals and does not react to new information in the

market, its rise can potentially create mis-pricing and make markets less efficient. A related argument is that passive investing can lead to significant concentration in the largest stocks. In the U.S., the top 10 companies make up nearly one-third of the S&P 500 index. When a company grows, passive funds allocate more money to it — regardless of its fundamentals.

18. This self-reinforcing cycle can inflate bubbles and make the index overly exposed to a handful of names. Volatility can also be intensified also by the way in which money flows, both in and out of an index fund, as passive funds create buy or sell orders for all stocks in the index at the same time. All shares, therefore, move in the same direction at the same time, and the benefits of diversification are reduced.

19. Paradoxically, some argue that the rise of passive may create new opportunities for active managers. Index funds are not looking for market anomalies, such as underpriced stocks which, in theory, should create more opportunities for active investors to find them. Moreover, in volatile or distressed markets, active managers can pivot, hedge, or exit. Passive funds, by design, cannot. This rigidity can be a disadvantage during extreme market conditions.

20. To my mind, both passive and active approaches serve different investor needs and can coexist productively. As regulators, our focus is on enabling the healthy growth of the mutual fund ecosystem as a whole — active or passive, and address the risks associated with each approach.

C. Key enablers for orderly growth

21. Let me now turn to some key enablers that I believe are important for the orderly and responsible growth of the passive industry.

22. <u>Policy initiatives for development of the passive industry</u>

    a. The first is the recent introduction of the 'MF Lite' regulatory framework — a more streamlined and facilitative regime for mutual funds that wish to focus exclusively on passive strategies.

b. The new regulations are aimed at reducing compliance responsibilities for passive only funds, fostering innovation, promoting ease of entry, and encouraging new players in the Mutual Fund industry.

c. Under the MF Lite Regulations, various aspects such as eligibility norms for sponsoring a mutual fund, roles and responsibilities of trustees, governance requirements, reporting obligations etc. have been relaxed.

d. In December 2024, SEBI issued a circular detailing the operational aspects including the eligible indices on which passive schemes can be launched under the MF Lite framework. To start with, only a limited set of indices have been prescribed.

e. In order to reduce volatility and difference of returns of ETFs/ Index Funds w.r.t its benchmark, limits have been placed on tracking error (for other than debt ETFs / index funds), and tracking difference, along-with their disclosure.

f. Existing Mutual Funds having both active and passive schemes have the option to hive off their passive schemes to a different group entity, thereby resulting in management of active and passive schemes by separate AMCs but under a common sponsor, subject to certain conditions.

g. The second significant policy development is the introduction of regulations for index providers last year. The regulations provide a framework for registration of Index Providers which license 'Significant Indices', that are defined on the basis of the AUM that are tracked or benchmarked by domestic mutual funds and have cumulative assets under management exceeding a specified threshold. The regulatory framework is in accordance with IOSCO Principles for Financial Benchmarks and only applicable to 'Significant Indices'. With these regulations, we aim to enhance transparency and accountability in governance and administration of financial benchmarks in the securities market.

23. <u>Governance</u>

a. In order to sustain the current growth story, it is essential for the mutual fund industry to uphold strong governance practices and maintain a reputation for integrity and reliability. Good governance assumes greater significance given the significant retail participation in MFs. Many of these retail investors are first time investors and it is important to maintain their trust in markets and specifically in mutual funds.

b. In this context, considering the front running instances in the past, we have in collaboration with AMFI, recently mandated AMCs to implement a structured institutional mechanism, which can proactively identify and deter instances of potential market abuse including front-running and fraudulent transactions in securities. This mechanism consists of enhanced surveillance systems, internal control procedures, escalation processes and a whistle blower policy.

c. Governance of corporates is another area where Mutual Funds, both active and passive, can play a significant role through their engagement, voice and voting. SEBI has been actively encouraging Mutual Funds to discharge their stewardship responsibilities.

24. Self-regulation

a. Self-regulation is an important component of good governance.

b. There is a noticeable increase in the complexity of products launched under the passive investing label. While innovation and product choice are welcome developments in any healthy market, it is critical that AMCs maintain discipline in product launches, and ensure clear communication of index methodology and risks.

c. The industry should ensure that the quest for AUM or incentives does not override the principle of suitability. The core promise of passive investing has always been simplicity, transparency, and low cost. We must be careful not to dilute this value proposition.

d. Investor education is also critical since low-cost does not equate to low-risk. Index funds still carry market risk, liquidity risk, and tracking error. SEBI has therefore directed AMCs and AMFI to carry out focused investor education and awareness initiatives for passive funds.

D. Concluding Remarks

25. To conclude, Mutual Funds are one of the most successful financial products that have stood the test of time and various bulls and bear cycles. I compliment the whole industry for contributing to the excellent growth of Mutual Funds in our country. But there is no room for complacency. Our job — as regulators, asset managers, advisors, and distributors is not just to grow AUM; it is to build an ecosystem that is inclusive, resilient, and ethical.

26. As we move forward, it is essential that the industry remains steadfast in its commitment to the fundamental principles of governance, accountability, and transparency. By doing so, we can ensure that the benefits of mutual funds - both active and passive — continue to expand, and contribute to a more financially inclusive and prosperous society.

Thank You !