Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Prelims and Mains focus: About ETFs, Bharat Bond ETF, advantages of ETFs over mutual funds

News: The Bharat Bond exchange-traded fund (ETF), which has opened for subscription, is a new category of debt investment with the benefits of low-cost passive investing in a fixed maturity product that invests in a portfolio of AAA-rated bonds.

What is the Bharat Bond ETF?

It is an investment product that invests in a portfolio of AAA-rated bonds issued by government entities. The portfolio will mimic the Nifty Bharat Bond Index that includes bonds of issuers such as NTPC and REC. The three-year variant tracks the three-year Nifty Bharat Bond Index and matures in April 2023; the 10-year variant tracks the 10-year index and matures in April 2030. Investors will be allotted units in the ETF in demat form, which will be listed and traded on the stock exchange. On maturity of the ETF, the bonds held in the portfolio will also mature and the money received will be paid out to unit holders.

How is it different from other products?

Bharat Bond is a target maturity ETF unlike other ETFs and mutual fund (MF) schemes that are open-ended products. The three-year ETF will only invest in bonds with similar tenures and likewise the 10-year ETF. The tenure of the bonds will roll down over time and mature around the time of maturity of the ETF. The interest rate risk will thus come down over time, as bonds with lower maturity will see less volatility in their prices. The portfolio of other ETFs and MFs reflect the maturity band of the product category specified by SEBI: say, a short duration fund has to always run a duration between 1-3 years in its portfolio.

How does a target maturity ETF benefit its investor?

A target maturity ETF gives investors visibility on their yield: it’s like buying a bond and holding it to maturity. You will get interest payments and repayment of principal on maturity. Bharat Bond ETF will, similarly, hold a basket of bonds and receive coupon income and the repayment of principal on maturity, which will be distributed to the unit holders.

What is the likely yield for Bharat Bond ETF?

The fact sheets for the Bharat Bond indices indicate a yield of 7.58% for the 10-year index and 6.69% for the three-year index as on 5 December. The yields for the two variants are likely to be
around these levels. SBI’s fixed deposit rates for similar tenures is around 6.25%. The gains from the ETF held for over three years are taxed as long-term capital gains with indexation benefits, which reduce the incidence of tax, especially on the 10-year ETF. However, interest income on fixed deposit is taxed at the marginal rate of tax.

**How does the ETF manage risks?**

The structure of the Bharat Bond ETF eliminates the risk of volatility in net asset value for investors who hold the units to maturity. Sebi’s recent guidelines on ETFs capping the exposure to issuers at 15%, along with the quasi-sovereign nature of the issuers, makes the default risk in the investment negligible. As an ETF, the units are available for purchase and sale anytime during trading hours on the exchange. There are market makers, who will provide buy and sell quotes to ensure liquidity for the investors.

**What is an Exchange-traded-fund?**

**Benefits of ETF**

**Low Cost** – Unlike traditional mutual and index funds, ETFs have no front- or back-end loads. In addition, because they are not actively managed, most ETFs have minimal expense ratios, making them much more affordable than most other diversified investment vehicles.

**Liquidity** – Whereas traditional mutual funds are only priced at the end of the day, ETFs can be bought and sold at any time throughout the trading day

**Tax-Advantages** – In a traditional mutual fund, managers are typically forced to sell off portfolio assets in order to meet redemptions. Often, this act triggers capital gains taxes, to which all shareholders are exposed. By contrast, the buying and selling of shares on the open market has no impact on an ETF’s tax liability

While IPOs and stake sales depend on market conditions and investor appetite, exchange-traded funds allow the government to lower its holding in public sector companies without being concerned about the volatility in the market

**Disadvantages**

Although exchange-traded funds offer several advantages over traditional mutual funds, they also have distinct disadvantages.

The securities that an ETF tracks are largely fixed, so investors that prefer active management will probably find ETFs wholly unsuitable.
Since ETFs are traded as stocks, each ETF purchase will be charged a brokerage commission.

PSUs suffer from constant government intervention in their business and pricing decisions which can have serious impact on returns on investment.