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BOND ETFs CAN BE A GAME CHANGER FOR INDIA'S DEBT INVESTMENT LANDSCAPE

POWER POINT

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Globally, fixed-income exchange-traded funds (ETFs) are a trillion-dollar asset class and an essential part of retail investors' portfolios. And, importantly so. Robust bond markets are integral for stimulating resource mobilization and allocation to critical economic activities. However, retail participation is low in India's bond market due to opacity around pricing, wide bid-offer spread and general inaccessibility.

Corporate bonds help issuers raise funds more efficiently while providing investors another avenue. However, the instrument is under-penetrated in India. Currently, the corporate bond outstanding to the country's GDP ratio is 17%, which is one of the lowest in the world. In advanced economies, the ratio is much higher. For instance, it's 123% in the US, 34% in Singapore and 74% in South Korea. Further, retail investors account for only 3% of the total corporate bond outstanding issuance in India. India currently has six fixed-income ETFs (including government securities and overnight funds) but none on corporate bonds, except the recently launched Bharat Bond ETFs. Together, these have meagre assets under management (AUM) of about ₹2,500 crore.

There are multiple causes for the anomaly. On the supply side, corporate issuers prefer raising capital from banks over issuance of bonds, primarily due to the lower cost of borrowing, less disclosure, and compliance and operational ease. On the investor front, the high percentage of over-the-counter (OTC) deals, private placements, large ticket sizes, difficulty in sourcing information, low volumes and illiquidity discourage large-scale retail participation in the bond markets. Further, the median cost of investing in bond funds in India comes at up to 100 basis points. Indian retail investors have been parking their savings in traditional fixed-income products such as fixed deposits (FDs), Public Provident Fund (PPF) and post office deposits, among others.

BHARAT BOND ETFs CAN MAKE A DIFFERENCE

Bond ETFs can help overcome the challenges facing retail participation in India's bond markets and leverage a huge opportunity in the process. The introduction of corporate bond ETFs through the launch of Bharat Bond ETF could be a game changer in India's fixed-income investment milieu. The Bharat Bond ETF will be a target maturity exchange-traded bond fund predominantly investing in the constituents of Nifty Bharat Bond Index. Target maturity ETF means that it will have a fixed maturity period and at the time of maturity, investors will get back their investment proceeds along with returns.

As a target maturity bond ETF, the Bharat Bond ETF seeks to address most of the issues deterring India's retail investors from investing in the corporate bond markets. It offers higher safety by investing in higher-rated bonds, transparency, liquidity (no lock-in), reasonable predictability of returns and tax efficiency.

> Corporate bond ETFs have the potential to draw a large pool of Indian retail investors

The structure has the potential to reshape the country's inherent preference for fixed-income products. But driving awareness is a critical factor to make this happen.

THE CORPORATE BOND EDGE

Here's why corporate bond ETFs have an edge over conventional debt instruments.

Accessibility: Corporate Bond ETFs make bond markets more accessible to retail investors by reducing the ticket size and providing exposure to a diversified basket of issuers. The Bharat Bond ETF, for instance, has a small ticket size of ₹1,000.

Tax efficiency: Debt instruments such as FDs are taxed as per investors' marginal tax rate. Unlike these, corporate bond ETFs offer the benefit of indexation for long-term capital gains when investments are held for three years or longer terms.

Transparency: Portfolio holdings of ETFs are disclosed daily as opposed to monthly disclosures by debt mutual funds. The availability of live-traded prices on exchanges continuously update investors about the investment value of their portfolio.

Liquidity: Just like stocks, corporate bond ETFs are traded on exchanges. This makes them more liquid than mutual funds, which can be traded only at net asset values (NAVs) declared at the end of the day.

Laddering: The target maturity debt ETF structure offers the potential to create a ladder structure. This enables availability of ETFs for each of the next 10 years. Similarly, investors have the choice to invest in ETFs across various years.

Predictability of returns: The returns expected from target maturity ETFs are close to the average yield of the ETF at the time of making the investment, provided the investment is held till maturity and the absence of credit events in the fund.

In essence, corporate bond ETFs have the potential to draw a pool of retail investors and become essential portfolio construction tools. The Bharat Bond ETF is a promising start. By entailing good quality credit issuers, low cost, liquidity, tax efficiency and high predictability of returns, the product has the potential to change the way India invests. Increased retail participation will strengthen India's corporate bond market. This, in turn, will contribute to the creation of a viable alternative to institutional channels for the short- and long-term financing needs of critical economic activities.

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