MUTUAL FUND
BAJAJ

WHAT ARE
INDEX FUNDS AND ETFs?

THE EQUITY COMPASS | EDITION 19

Understanding two ways to follow a market index

Think of watching the same movie in two different formats: in 4DX at a cinema or via online streaming at home.

The content remains the same, but the way you access it and interact with it differs. Similarly, an index fund and an ETF may track the same index, while the mechanism through which investors access them differs.

WHAT IS A MARKET INDEX?

A market index is a rules-based basket of securities designed to represent a particular market, segment, sector, or investment theme.

The securities included in an index and their respective weights are determined according to the index methodology. As prices and market conditions change, the value of the index also changes.

An index serves as a benchmark. It cannot be invested in directly. Index funds and ETFs provide investors with a way to gain exposure to the securities represented by that index.

WHAT IS AN INDEX FUND?

An index fund is a mutual fund scheme designed to replicate the performance of a selected market index.

Instead of choosing securities based primarily on the fund manager's individual investment view, the fund generally invests in the securities included in the underlying index, in approximately the same proportions.

Investors purchase or redeem units through the mutual fund or an investment platform at the applicable Net Asset Value, or NAV.

The objective of an index fund is not to outperform its benchmark. It seeks to deliver returns close to those of the underlying index, subject to expenses and tracking differences.

WHAT IS AN ETF?

An Exchange Traded Fund is an investment fund whose units are listed and traded on a stock exchange.

Many ETFs are designed to track a market index. Like an index fund, an index-tracking ETF generally holds securities represented by its underlying benchmark.

However, ETF units can be bought and sold during market hours at the prevailing market price, in a manner similar to listed shares. Investors typically require a demat and trading account to transact in ETF units on an exchange.

The market price of an ETF may differ slightly from its NAV depending on factors such as demand, supply, liquidity, and the bid-ask spread.

Name of MF – Bajaj Finserv Mutual Fund | Registration no. – MF/078/23/04

INDEX FUNDS AND ETFs: HOW ARE THEY DIFFERENT?

PARAMETER	INDEX FUND	ETF
Structure	Open ended mutual fund scheme	Mutual fund scheme listed and traded on a stock exchange
How units are transacted	Purchased or redeemed through the fund or a platform	Bought and sold on a stock exchange
Transaction price	Applicable NAV	Prevailing market price
Trading during the day	Not available	Available during market hours
Account requirement	Mutual fund folio required, demat account is optional	Demat and trading account are generally required
Liquidity	Transactions take place with the mutual fund at the applicable NAV	Depends on trading activity and the liquidity of the underlying securities
Additional transaction considerations	Scheme expenses and any applicable loads	Scheme expenses, bid-ask spread, brokerage, and other applicable charges
Regular investing	SIP facilities are generally available	Depends on the investor's broker or investment platform

WHY CAN RETURNS DIFFER FROM THE INDEX?

Although an index fund or ETF seeks to replicate its benchmark, its return may not match the index exactly.

FACTOR	HOW IT MAY AFFECT PERFORMANCE
Expense ratio	Operating expenses may reduce returns relative to the index
Cash holdings	A small cash balance may cause the portfolio to behave differently
Index rebalancing	The timing and cost of portfolio changes may create differences
Transaction costs	Buying and selling securities may affect replication
Corporate actions	Dividends, mergers, or other events may influence tracking
Replication method	The fund may not always hold every security in precisely the same weight

Two measures can help investors assess replication:
Tracking difference measures the difference between the returns of the fund and its underlying index over a specified period.
Tracking error measures the variability in the difference between the fund's returns and those of its underlying index, indicating the consistency with which the fund tracks the index.
A fund with a low tracking error has generally followed its benchmark more consistently. However, both measures should be reviewed over a meaningful period and alongside costs and portfolio structure.

Index funds and ETFs may follow the same road, but they provide different ways to begin, manage, and complete the investment journey. The appropriate structure depends on the exposure required and how the investor prefers to transact.