Current State of Mutual Funds in India

Episode 81 | Big Ideas

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Transcript

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Abstract

Sanjiv Shah has spent his career at the frontier of India's asset management industry, having co-founded Benchmark Asset Management, a pioneer of ETFs in India, and now running Lakshya Asset Management. In this conversation, he traces the extraordinary growth of India's mutual fund industry from roughly fifteen lakh crores before COVID to nearly eighty lakh crores today, and from four crore to fourteen crore investor folios. He explains how this growth has "democratized" access to markets, with new participation increasingly coming from states like Uttar Pradesh rather than the traditional financial hubs of Bombay or Gujarat.

From there, Sanjiv moves into a sharper argument: despite this growth, Indian investors remain dangerously undiversified. Nearly all their equity exposure is domestic, and their only real hedge against the rupee has historically been gold, not foreign equities. He points out that regulatory limits on mutual funds investing abroad have already been breached, effectively closing off that route, while the LRS (Liberalised Remittance Scheme) channel remains underused. He also turns the lens on foreign investors, arguing that shifting tax treaties and jurisdictional uncertainty are pushing FIIs away from India, and that Indian retail flows through SIPs have ironically made it easier for foreign investors to exit.

The conversation closes with Sanjiv's policy prescription: reduce friction on both sides of the border, so foreigners find it easy to enter India and Indians find it easy to diversify their savings abroad. What follows are his detailed arguments on each of these points, moving from the scale of the mutual fund boom to the structural risks of home bias and finally to what he sees as the fixable policy problems facing India's capital markets.

Supplementary Resources

- **SEBI Increases Foreign Investment Limit For Mutual Funds To $1 Billion** by Capital Market (Resource) [1]

- **Why India's high taxes are proving to be a buzz-kill for global investors** by Catherine Bosley and Abhishek Vishnoi (Resource) [2]
- **India scraps tax on overseas bond investors in bid to attract foreign capital and shore up the rupee** by Priyanka Salve (Resource) [3]
- **India's Gold Story: Rising Imports, Household Demand, and RBI Reserves** by Sai Krishna Muthyanolla (Resource) [4]
- **Policy information uncertainty and foreign institutional investors trading behavior: evidence from India** by Chandra Thapa, Biwesh Neupane, Chaman Shrestha and Narayan Prasad Bhattarai (Journal article) [5]

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Introduction to the mutual fund landscape

[00:00:08] Sanjiv Shah: Welcome to Big Ideas. We are here with Mr. Sanjiv Shah, who is a pioneer for in India for ETFs. He co-founded Benchmark Asset Management and now he is a founder of Lakshya Asset Management.

[00:00:08] Sanjiv Shah: And we are here to pick his brains on the mutual fund industry and the current situation that is facing India.

[00:00:30] Sanjiv Shah: Because of outflows of FIIs and what do you think is the current situation and what do you think we should do?

Growth and democratization of mutual funds

[00:00:40] Sanjiv Shah: So, the mutual fund industry has come a long way in India. What has happened really is basically if you look at the size of the industry which used to be nearly about fifteen lakhs pre-COVID, has gone up to nearly eighty lakh crores. Now, this is substantially large and there used to be about four crore investors. That could have been either single names or double names, so it may not be four crore investors, now they're nearly fourteen crore investors.

[00:01:07] Sanjiv Shah: And if you look at the data, and which is logical also, is that basically more people from UP are actually creating new mutual fund folios as compared to what you typically get in Bombay or Gujarat or whatever. So in that sense, if I can say that, the mutual fund industry has democratized. More and more people are participating in the industry. And as you just mentioned that basically the FIIs have gone, literally in a sense Indian retail investor has provided them an exit route.

[00:01:37] Sanjiv Shah: A lot of people have different views on this, whether we should have or not, but leave that aside. Every month when you have thirty thousand crores of SIPs coming in, the foreigners have been able to get out much more easily as compared to other markets. I mean, look at China and it's very difficult for them to exit and all that. But India has provided them that and that whole burden has been taken over by the mutual funds.

[00:01:37] Sanjiv Shah: So it's in terms of size it's become a pretty substantial and a very important segment of the financial markets.

[00:02:04] Sanjiv Shah: So if you look at, even five years back pre-COVID, mutual funds were a bit player. I mean, I'm not saying they were not important, but they were bit players. But now mutual funds have become the key source of gathering of savings in this country. So that's what the big change has been in the mutual fund industry.

[00:02:25] Sanjiv Shah: Understood.

How Indians are investing and diversification gaps

[00:02:27] Sanjiv Shah: So, another question that I had was that how are Indians investing in the current landscape with increase, like you said, increasing mutual funds, people are investing more in stocks. What do you think is the impact of that? How do you think Indians invest in general? You think they are able to diversify well when they invest abroad, when and if they can invest abroad?

[00:02:27] Sanjiv Shah: What are your thoughts on that?

[00:02:49] Sanjiv Shah: So sure, let me break down the question. So Indians until now have not been big investors in equity, until ten years back. And as I said, they've increased the folios from four crores to fourteen crores, but even then they were most of the people were investing in debt. Now what has happened fortunately is basically the most of the Indians who are coming in new are participating in the growth of the Indian markets, in the equity markets.

[00:02:49] Sanjiv Shah: So, in a sense their returns are much higher than what would have been their parents and so on and so forth.

[00:03:21] Sanjiv Shah: Most of the parents of, if you want to call it Gen Z would be investing in bank deposits or government securities and they would end up with seven, eight, ten percent or whatever. Now, Indian youth has started seeing that basically they can actually get much more returns when you're investing in equity. The second part of it is that because the EPFO has started investing in ETFs, what has happened also is that basically the normal provident fund, really small worker — I won't even call it investor, small worker — is getting, is partaking to some extent some of his savings into equity.

[00:04:02] Sanjiv Shah: So when the EPFO becomes large, hopefully over a period of the next twenty, thirty years, and they increase their allocation to equity, I think basically the Indian citizen in general will be much better off. I mean, I'm sure you know about the US and you have the idea of 401ks and all that, and that has — if you remember — for the boomers, that became a very important source of wealth. And that I hope in the next twenty, thirty years becomes a very critical component for Indian investors.

[00:04:33] Sanjiv Shah: Now, one thing, it's all India. Most of the investments for Indians is in India. But most of the investors invest in India. If you look at the fact that basically the last three, four years what has happened is most of the world markets have been way better than India.

[00:04:33] Sanjiv Shah: Obviously the selling of the foreigners, Indians have as I said, allowed them to basically have the exit. But on the other side, Indians have invested in India, so their growth, if you look at the returns for most of the Indians in the last two, three years, has not been there.

[00:05:05] Sanjiv Shah: Now, the principle of equity investing is diversification. Indians unfortunately have not been able to do that. There are a couple of points which I'll highlight. There used to be a limit of about eight billion dollars for mutual funds which can invest outside of this country.

[00:05:05] Sanjiv Shah: Now that limit has been breached. We, when we were in Benchmark, we actually came up with the idea of the Hang Seng index where Indians could invest outside of this country. Now, unfortunately, all the mutual funds put together have a limit of eight billion dollars and that has been breached.

Restrictions on investing abroad and gold as a hedge

[00:05:37] Sanjiv Shah: And the amount of money which Indians can now invest through mutual funds is near zero now, as of today. There is another route called the LRS route. Unfortunately, there also most of the Indians have not really caught up to investing in international markets. Now, you may call it home bias as it usually happens.

[00:05:37] Sanjiv Shah: But if you were an investor and if you had invested outside of this country, your returns were far, far higher than what you got in two years.

[00:06:04] Sanjiv Shah: My personal view is that basically Indians now have to really start thinking about investing outside. Obviously the regulator has to help in terms of increasing the limits of the mutual funds, also allow the LRS to be much more easier for people to do. But I think it's time that Indians should be diversifying themselves. Most of the people in India were really diversifying through gold.

[00:06:27] Sanjiv Shah: We actually had the concept of gold ETF and what we saw over a period of time is that basically the Indian investor actually invests in gold. I mean, there is whatever history, there is a sentimental value, there is emotional value, there is a social value. But you would be surprised to know that one of the big reasons why Indians invest, they were actually hedging their forex risk. It's very interesting that Indians intuitively know that basically, just being in the rupee doesn't help.

[00:06:27] Sanjiv Shah: So that's why, and right now we are talking about the fact that basically the imports are impacting and all that.

[00:07:00] Sanjiv Shah: But the reality is Indians are buying. See, now the government of India is trying to limit how much you can invest in equity outside of this country, but in reality, gold itself is an investment outside of this country. So, it's not that Indians don't know how to invest outside the country, but they know it's much more rudimentary than what we would think and I think it's time for mutual funds to step up and make sure that we invest outside of this country. So in terms of cross-border flows also, one of the biggest, second most biggest import for India now is gold, after oil.

[00:07:30] Sanjiv Shah: Oil is basically a commodity which is used and really speaking, in my view, it's only investments. That is really investments and Indians are investing. So if you look at thirty, forty billion — I don't know the exact numbers, but if you look at thirty, forty billion — Indians are investing outside of this country. So why not allow that thirty, forty billion to in fact be invested in more growth assets rather than just pure gold.

[00:07:30] Sanjiv Shah: I think that's some policy question which the government should think about.

[00:07:55] Sanjiv Shah: And on the other side, let's put it the other side, one of the — we talked about the fact that basically foreigners are not investing or sold out and we have been seeing that big flows coming through into India. Now, one of the big reasons is again cross-border and is that the frictions which we have created for them to come in also are very high. We've got capital gains which never existed. We've created structures where basically if you come from different jurisdictions, it becomes a pain.

[00:07:55] Sanjiv Shah: So I think that basically we need to also make that very simple.

[00:08:26] Sanjiv Shah: Let foreigners come in, be it GIFT City, be it Singapore, be it Mauritius, don't make it tough for most of the foreigners to come in. And I think, a cross-border movement where Indians also invest outside and foreigners also invest into India will allow opening up of the rupee-dollar market. It'll allow, in my view, reduction in imports of gold. Yeah, you might see some flows going into equity investments outside of India, but again, I believe that that'll be much more healthier than just investing in gold.

[00:08:56] Sanjiv Shah: So I think these are the policy questions which I think we need to address now and address very substantially as we move forward.

Home bias and overreliance on domestic risk

[00:09:05] Sanjiv Shah: Given that Indians are not allowed or, restricted from moving their money abroad in terms of investments and the only hedge is gold or just investing in the domestic market, don't you think the Indians are more reliant on domestic risks for their investments?

[00:09:23] Sanjiv Shah: Absolutely right. So if you look at it, basically, we are now stuck in a portfolio. What is basically portfolio theory telling us? Portfolio theory tells us that basically you can't put all your eggs in one basket.

[00:09:23] Sanjiv Shah: And that's where the whole concept of ETFs, concept of index funds — and that's why they are beating the active managers also. The concept is that basically, diversify as much as you possibly can because you don't know which one particular asset will not do well in a particular time or which one particular asset will do well. So you diversify yourself.

[00:09:51] Sanjiv Shah: Now, we are being forced, the Indians are being forced to invest only in the Indian market. As I mentioned, it's not that basically we are not investing outside, we're investing through gold. So we are only buying one asset class outside of India where basically it is gold — gold actually denominates both, price of gold and dollar. Because basically you're taking dollar risk also.

[00:09:51] Sanjiv Shah: But you're not investing in the growth of other markets.

[00:10:18] Sanjiv Shah: Now we all know basically the whole AI driven markets in US, Nasdaq has given nearly sixty percent in the last two, three years. We Indians have missed out. South Korea, Taiwan, and to some extent even Japan which has not moved, is giving much more better returns — would have given better returns to Indians than what most Indian markets have done. So, the first lesson is that basically even though Indians are diversifying in gold, they are not participating in the growth rates of the other one.

[00:10:18] Sanjiv Shah: One can argue that basically gold prices have gone up and all that, but again, one asset class, only limited to one thing.

[00:10:53] Sanjiv Shah: It's better that Indians actually diversify into different asset classes and let the thirty, forty billion which is going out in gold be allowed to be invested in other equity markets of the world.

Attracting FII flows and reducing regulatory friction

[00:11:05] Sanjiv Shah: A follow up to that, when you said that other countries have performed much better because of their companies that are heavily into AI like South Korea or Japan or US — as in India, when we talk about FII flows, we are competing against these countries to get these flows. And for the case of India, it's quite dire because the market has not moved by that much and on top of that the rupee has depreciated. So when an FII investor looks at India, what do you think his reaction is to the current situation and what do you think India should do and can do to make investments more attractive inside of India?

[00:11:48] Sanjiv Shah: So, I have a very simple philosophy that basically one can never know how the markets function. So if you look at the fact that basically the foreigners went out, they would have — I mean, in today's hindsight you would say they were very smart. They actually sold out when the rupee was eighty-four, eighty-five, whatever, and now it's ninety-five and the markets have not gone up. So they're much better off.

[00:11:48] Sanjiv Shah: Now on the flip side of it, one can argue that basically Indians, foreigners, given that it's now rupee at ninety-five, given the valuations have not gone up, it's a great time to buy.

[00:12:17] Sanjiv Shah: But obviously, one never knows how the markets function. Our companies have to keep growing. I mean, that's a given. Whenever our companies grow, it doesn't matter whether it's AI driven, not AI driven, but if they actually make profits, they will come in.

[00:12:17] Sanjiv Shah: So I don't think we should worry about the fact that basically how the Indian companies will do. What we should do is basically reduce the friction for the foreigners to come.

[00:12:41] Sanjiv Shah: Don't, when you come in through one jurisdiction, change the law of that particular double taxation treaty and make it uncertain for the foreigner to think that basically, look, I invest, I think I'm going to pay a zero tax or I'm going to pay ten percent tax and suddenly you find that I'm going to pay twenty percent tax. And then suddenly you say, no, you don't come from this jurisdiction, come from that jurisdiction. I think we should make it so simple that I'm a foreigner, I want to invest in India, I want to remove as many frictions as possible.

[00:13:13] Sanjiv Shah: Because the day the person decides that basically India is a good market, let him make that decision and actually implement that. Now in this case, right now what we are doing is putting barriers. We're putting barriers in terms of what FPI should be, how to take the approval to become an FPI, which jurisdiction I should come from. Okay, I come from that jurisdiction, today the tax laws are X, tomorrow it will become X minus Y.

[00:13:13] Sanjiv Shah: So I'm making it so difficult that the foreigner is thinking hell with it, yeah.

[00:13:46] Sanjiv Shah: I mean, yeah, India is a great market and all that and I got exit also, but yeah, better markets somewhere else. So I would, as a policy maker, make it so frictionless that okay, you may not like India today, but six months down the line you might like India. And that's where you basically come in and say, damn it, come, invest, pay the tax which I'm telling you to do and I'm not going to change that tax and you can take the money anytime you want, and which we have demonstrated. So I think that's the way forward for us.

[00:14:18] Sanjiv Shah: All right. Thanks a lot for your...

[00:14:19] Sanjiv Shah: Thanks.

[00:14:20] Sanjiv Shah: Yes, it was very insightful.

[00:14:22] Sanjiv Shah: Thank you.

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