To,
NSE Indices Limited
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Mumbai - 400 051

Via email to: index-consultation@nse.co.in

Sub: Public Consultation on NIFTY 50 Index Criteria

At the outset, we, at Indian Association of Investment Professionals (IAIP), a member society of the CFA Institute appreciate the opportunity to submit our response to the CONSULTATION PAPER ON NIFTY 50 INDEX CRITERIA.

IAIP is an association of over 2000 local investment professionals who are CFA charter holders and about 4000+ professionals who have cleared exams, eligible and awaiting charter. The Association consists of valuation professionals, portfolio managers, security analysts, investment advisors, and other financial professionals, that; promote ethical and professional standards within the investment industry, facilitate the exchange of information and opinions among people within the local investment community and beyond, and work to further the public’s understanding of the CFA designation and investment industry.

CFA Institute is a global non-profit association of investment professionals with over 155,000 members in over 152 countries. In India, the community of CFA charter holders is represented by the Indian Association of Investment Professionals.

Through our global research and outreach efforts, CFA Societies around the world endeavour to provide resources for policy makers, financial services professionals and their customers in order to align their interests. Our members engage with regulators in all major markets.

With regards to the above-mentioned consultative paper, we have proposed a few suggestions.

We would be happy to hear and discuss the merits / demerits of suggestions proposed by other practitioners and request to be included in the deliberation process.

Our responses to the specific questions as per the addendum to the consultation paper are mentioned below:

A. Details of our Organisation:
   1. **Name:** Indian Association of Investment Professionals (CFA Society India)
   2. **Contact number:** +91 98196 30042
   3. **Email address:** advocacy@iaipirc.org
   4. **Postal address:** 702, 7th Floor, A Wing, One BKC Tower, Bandra Kurla Complex, Bandra (E),
      Mumbai - 400 051
B. Key Contributors:

1. Mr. Anil Ghelani, CFA
2. Mr. Soham Das, CFA
3. Mr. Ujjwal Jain, CFA
4. Mr. Prakash Saraff, CFA

C. Suggestions / Comments:

1. Need to introduce sector weight caps in NIFTY 50 index

   1) In your opinion, is there a need to introduce sectoral weight cap in NIFTY 50 index?

      Response: No

      Rationale:

      *No Value Addition for Market Participants*

      Weight capping of a sector during index composition is effectively similar to asset managers who hold a modified version of the index, to outperform the benchmark. This style of investing is called “smart beta” in the industry.

      This change adds little value to market participants, as such investment products are already available with a NIFTY 50 derived index as the underlying [1].

      *Poor outcomes for fast growing index fund industry*

      Incorporating such a cap, would also lead to frequent rebalancing of the index, as high as 4 times a year, as also hinted in the original consultation paper.

      Such frequent rebalancing incurs higher costs, and hence higher tracking errors for passive index funds. This can slow down the growth of passive fund industry, otherwise a fast growing pocket of asset management industry, with potential to attract significant long-term capital in the years to come.

      *Not in consonance with underlying economic reality*

      Financial services sector consistently ranks 2nd in terms of gross value added to output [2], as per National Accounts Survey 2018 (MoSPI) from 2013-14 to 2015-16, exceeded only by agriculture – an industry with a high degree of government intervention. Its only in FY17, after public banks were grappling with delinquent assets and credit growth slowed down in 2017 [3], that this rank fell to 7th.

      Financial Services sector is a highly efficient sector. The high degree of private investment makes it a favourite for investing in the Indian growth story. The higher weightage of this sector in NIFTY 50 is a reflection of this importance.

      Alternatively, the lower comparative weightage of other sectors is a symptom of their inefficiency and not necessarily a shortcoming of NIFTY 50.
Lack of transparency around the policy can create significant costs

Sectoral weight capping doesn’t account for the future ‘edge’ cases, when other industries come to dominate the index (energy led by Reliance Industries dominated NIFTY 50 for a considerable amount of time). In such cases, the policy and method of capping (of new dominant sector), uncapping (older dominant sector) and re-capping is not clear.

Such uncertainty can have the effect of creating significant ‘cost’ on market participants as one has to analyze not only the economic variables but also the regulatory action. This can hamper price discovery, popularity among foreign portfolio investors and market efficiency.

Sector domination as a ‘feature’, not a ‘bug’ & adhering to free market principles

Market capitalization weighted indexes tend to be dominated by industries that contribute the most to the economy. For example, Brazil’s flagship index iBOVESPA was dominated by energy for a long time [4]. Russian index, MOEX is still dominated by energy [5]. NIFTY 50 was also in the past dominated by different sectors like infrastructure & real estate companies in 2007 (DLF, Unitech). Such a behaviour is a ‘feature’ and not a ‘bug’ of market cap weighted indexes. This allows policymakers and economy observers to understand drivers of growth at a granular level. Further, it offers crucial information about growth expectations of individual sectors, higher valuation premium indicative of higher expected growth.

Capping the sectoral weight distorts this signal and may mislead policymakers and investors. Most importantly, such capping policy is not in consonance with free market principles.

2) If your response to above question is ‘YES’, what, in your opinion, is the most appropriate sectoral weight cap for a sector in NIFTY 50?

Response: N/A

2. Need to introduce surveillance and risk related parameters imposed by the exchanges for selection of stocks in NIFTY 50 at the time of periodic reconstitution of NIFTY indices

1) Should stocks that are subject to additional surveillance margin requirement for one year period or more be considered ineligible at the time of reconstitution of NIFTY 50?

Response: Not in Favour at this point of time.

Rationale:

Effects of surveillance related filters should be studied before implementing them on NIFTY 50. Additional data points of such measures are needed from other parts of our own and from international markets.

In essence, any such measure will have to be assessed on their effect (to trigger no unintended consequences), efficacy (to achieve what has been intended) and efficiency (to achieve with minimum disruption).

In light of limited studies and data, the Society is not in favour of introducing such measures at this point in time.
If you or your staff have questions or seek further clarification, please do not hesitate to contact Mr. Rajendra Kalur, CFA @ +91 98196 30042 or at advocacy@iaipirc.org

Sincerely yours,

Rajendra Kalur, CFA
Director - Research and Advocacy Committee
Indian Association of Investment Professionals, Member Society of CFA Institute