

# Index Funds are a Trap for Indian Investors. Fight Me.

In the investing world, few topics spark as much debate as passive versus active investing. While index funds have become the darling of developed markets, I'm here to argue that blindly following this trend is a costly mistake for Indian investors. This isn't just contrarian thinking—it's based on hard evidence about India's unique market dynamics and the opportunities that passive investing completely ignores.

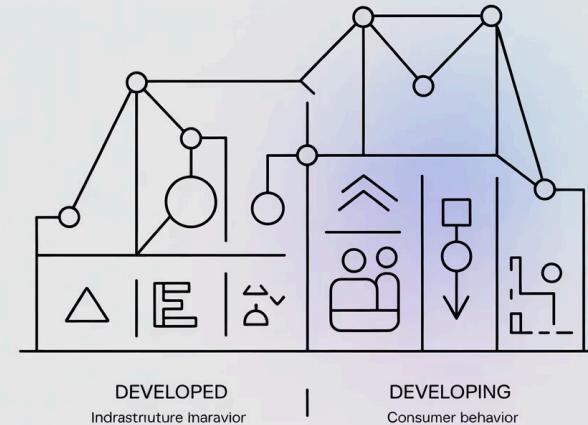
# The Global Hype vs. Indian Reality

The passive investing revolution has swept through developed markets like a tsunami. In the United States, index funds dominate with their promise of low costs and market-matching returns. But here's what the cheerleaders won't tell you: what works in mature, efficient markets like the US doesn't necessarily translate to dynamic, developing economies like India.

India's equity markets remain wonderfully inefficient, creating genuine opportunities for skilled active managers to add real value. The market microstructure, regulatory environment, and investor behavior patterns are vastly different from developed markets. Yet passive investing now accounts for 17% of India's mutual fund assets —a staggering ₹75 lakh crore as of July 2025.

This surge in popularity doesn't equal suitability. Indian markets are characterized by rapid sectoral shifts, regulatory changes that can overnight change industry dynamics, and emerging companies that indices are slow to capture. These are precisely the conditions where active management thrives, not where passive strategies excel.

## Developed vs. Developing Markets



- ⓘ **Market Reality Check:** Indian markets exhibit higher volatility, greater sector rotation, and more pronounced inefficiencies compared to developed markets—creating natural advantages for active management.

# The Illusion of Diversification

Index funds are marketed as the ultimate diversification tool, but this is a dangerous oversimplification when it comes to Indian indices. When you buy a Nifty 50 index fund, you're not getting true diversification—you're getting concentrated exposure to whatever happens to be large and liquid at that moment.

## Sector Concentration Risk

Financials dominate the Nifty 50, creating massive sector bias. When banking stocks crash, your "diversified" index fund crashes with them.

## Fixed Proportions Problem

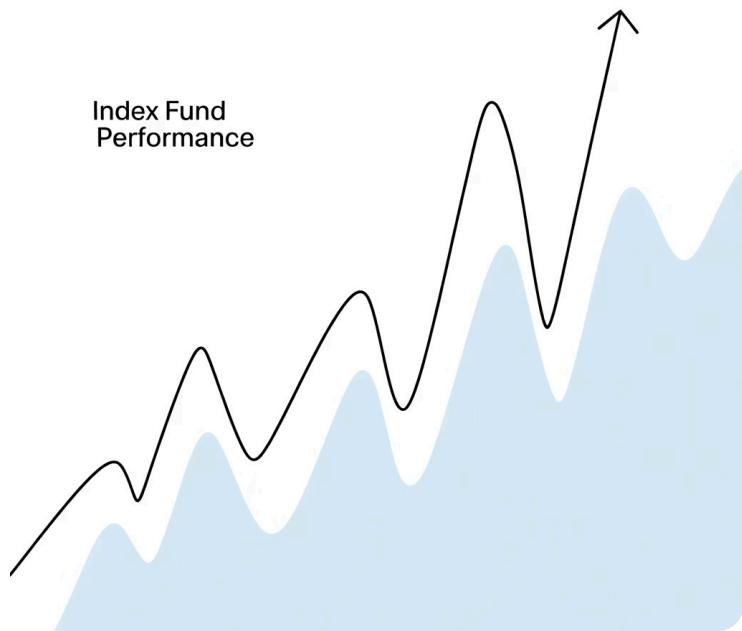
Index funds must hold stocks in predetermined ratios, regardless of valuation or fundamentals. You're forced to own overpriced stocks alongside bargains.

## Winners and Losers Together

There's no mechanism to avoid obvious losers or overweight promising opportunities. You get everything, good and bad, in fixed doses.

This isn't diversification—it's a straitjacket. Active managers can adjust sector allocations based on market conditions, regulatory changes, and valuation metrics. They can underweight overvalued sectors and overweight emerging opportunities. Index funds cannot make these crucial adjustments, leaving investors vulnerable to concentration risks that could be avoided.

# No Chance to Beat the Market



Here's the brutal truth about index funds: by design, they can only match market returns, never outperform them. This might sound acceptable until you consider what it really means in practice.

"You have no realistic chance of earning returns above the market; passive index investing is designed to simply mirror the index's performance."

— *Gunjan Chokshi, MD & CEO of Investallign*

In volatile markets or during downturns, this limitation becomes painfully obvious. Active fund managers can rebalance portfolios, reduce exposure to falling sectors, and protect capital through defensive positioning. Index funds have no such flexibility—they must ride every downturn to the bottom.

Consider the 2020 market crash or the 2008 financial crisis. While some active funds managed to limit downside through tactical asset allocation and stock selection, index funds simply followed their benchmarks down the cliff. The recovery benefits are often overstated because they ignore the permanent capital destruction that could have been avoided.

# Active Funds Still Outperform in India

Unlike in developed markets where active management has struggled, Indian active funds have historically delivered genuine alpha. This isn't luck—it's the natural result of operating in an inefficient market where skill and research can create real competitive advantages.



## Market Inefficiencies

Skilled fund managers can exploit pricing gaps, sectoral misvaluations, and information asymmetries that are abundant in Indian markets.

## Faster Adaptation

Active managers can pivot quickly to capitalize on regulatory changes, policy shifts, and emerging trends before indices adjust.

## Structural Changes

They can anticipate and position for long-term sectoral transformations that passive funds miss until it's too late.

Consider this historical example: the Sensex 30 in the 1980s was heavily weighted toward textile companies—a reflection of India's industrial structure at the time. Today, technology and financial services dominate. Active managers who recognized this structural shift early could reposition their portfolios accordingly, capturing the transformation premium. Index funds, by contrast, only reflected these changes after they became obvious to everyone.

The same pattern continues today with emerging sectors like renewable energy, electric vehicles, and digital payments. Active managers can identify and invest in promising companies in these spaces before they achieve the size and liquidity required for index inclusion.

# The Hidden Costs of Passive Investing

The low-cost narrative around index funds is one of their most compelling selling points, but it's also one of their most misleading. While expense ratios are indeed lower, the total cost of passive investing includes several hidden elements that can significantly erode returns.

## Tracking Error

Index funds don't perfectly replicate their benchmarks due to cash drag, transaction costs, and timing differences. These tracking errors compound over time.

## Sector Bias Costs

Being forced to hold overvalued sectors or stocks creates opportunity costs that are harder to quantify but very real.

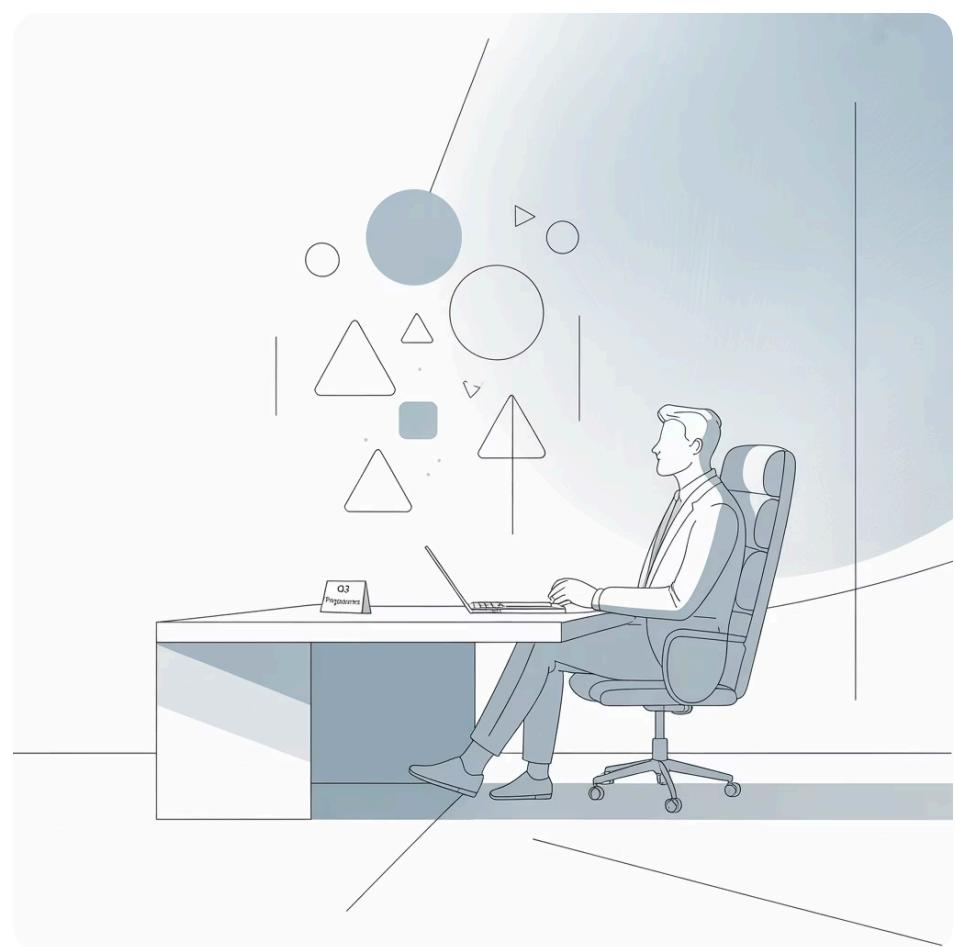
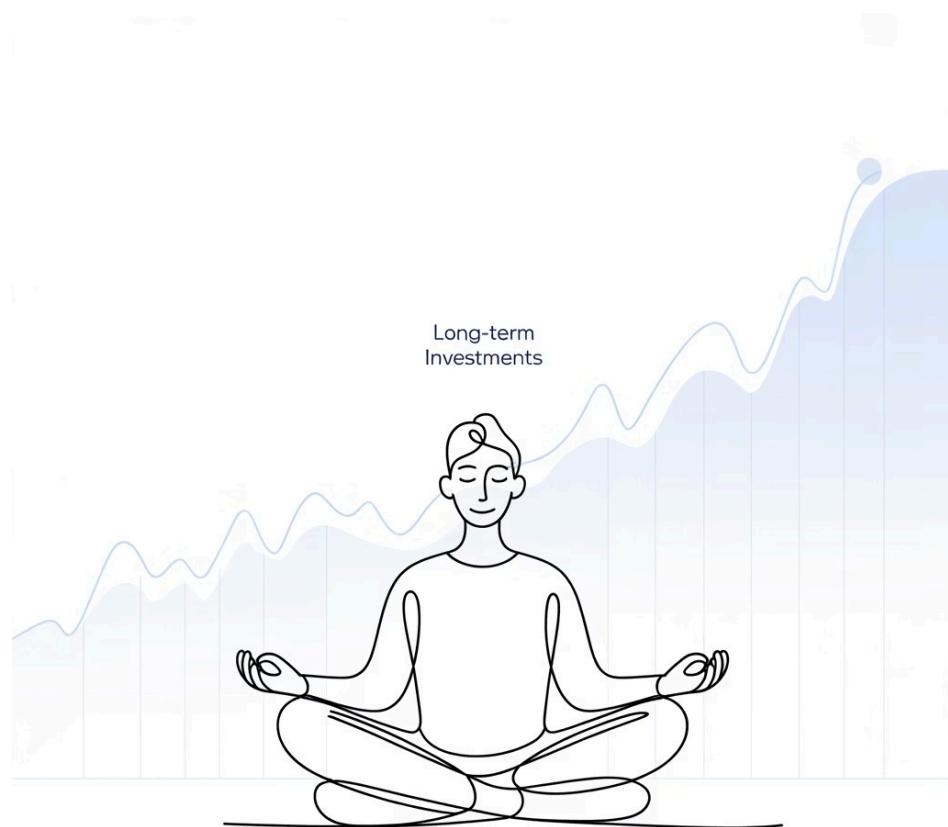
## International Exposure Pitfalls

US-listed India ETFs like INDY have underperformed their benchmarks by over 60% over 5 years due to currency risk, liquidity issues, and high expense ratios (0.89% vs. 0.05-0.3% in India).

The international exposure trap is particularly insidious for Indian investors. Many assume that investing in India-focused ETFs listed on foreign exchanges provides better access or lower costs. The reality is often the opposite—these products frequently underperform domestic alternatives due to currency hedging costs, lower liquidity, and higher expense ratios.

Retail Indian investors often overlook these nuances, assuming that "low cost equals better returns." This oversimplification ignores the total cost of ownership and the opportunity costs of passive strategies in inefficient markets.

# Investor Mindset: Patience or Performance?



## The Patience Paradigm

Index funds suit investors who are content with steady, market-matching returns and believe in the power of long-term compounding. This mindset views market volatility as noise and focuses on the long-term upward trajectory of equity markets.

These investors are typically satisfied with beta returns and don't want to worry about manager selection, style drift, or active management risks. They prefer the simplicity and predictability of passive strategies.

## The Performance Pursuit

Many Indian investors, however, seek market-beating returns and are willing to tolerate volatility in pursuit of alpha. They understand that with higher potential rewards come higher risks, but they're not satisfied with just matching market returns.

This investor mindset aligns better with active management, where skilled fund managers can potentially deliver superior risk-adjusted returns through research, timing, and selection.

**"Index funds are useful additions, but not the whole portfolio."**  
— *Anand Vardarajan, Tata AMC*

The key insight is that neither approach is inherently wrong—they serve different investor personalities and goals. However, the current discourse often presents passive investing as universally superior, ignoring the legitimate preferences and objectives of performance-oriented investors.

# The Danger of Herd Mentality

The surge in passive investing creates its own set of systemic risks that are rarely discussed in polite investment circles. When massive amounts of capital flow into index funds, they must buy the same stocks in the same proportions, regardless of valuation or fundamental merit.

01

## Inflated Valuations

Index-heavy stocks receive disproportionate inflows, potentially creating bubbles in large-cap segments while leaving mid and small-cap stocks undervalued.

02

## Reduced Price Discovery

With more passive capital, fewer market participants are actively analyzing and pricing securities, reducing market efficiency over time.

03

## Amplified Corrections

When market sentiment turns, passive outflows can amplify sell-offs as index funds are forced to sell across the board, regardless of individual stock fundamentals.

This creates a dangerous feedback loop: passive investing succeeds partly because of its own growth, but that same growth creates conditions that could undermine its future effectiveness. Overcrowding in a handful of large-cap stocks makes the entire market more fragile and susceptible to sharp corrections.

Active funds provide a crucial counterbalance by diversifying beyond index constraints, conducting independent research, and making investment decisions based on fundamental analysis rather than market-cap weighting. This helps maintain market efficiency and provides stability during volatile periods.

# What Should Indian Investors Do?

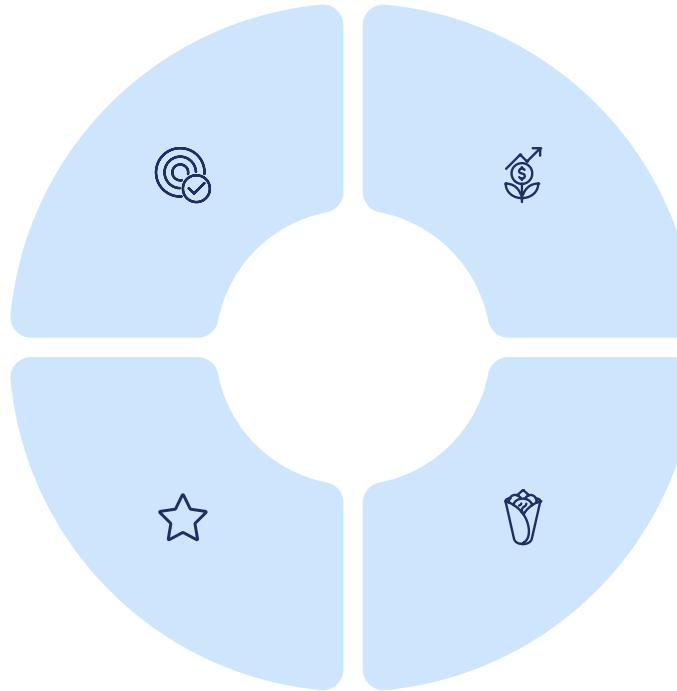
The solution isn't to completely avoid passive investing or to go entirely active. Instead, Indian investors should adopt a nuanced approach that leverages the strengths of both strategies while acknowledging their respective limitations.

## Goal-Based Allocation

Align investment strategies with specific financial goals, risk tolerance, and time horizons rather than following generic advice.

## Dynamic Rebalancing

Regularly review and adjust the active-passive mix based on market conditions, valuations, and changing personal circumstances.



## Active for Alpha

Use active funds to capture opportunities in emerging sectors, market inefficiencies, and during volatile periods where skill can add value.

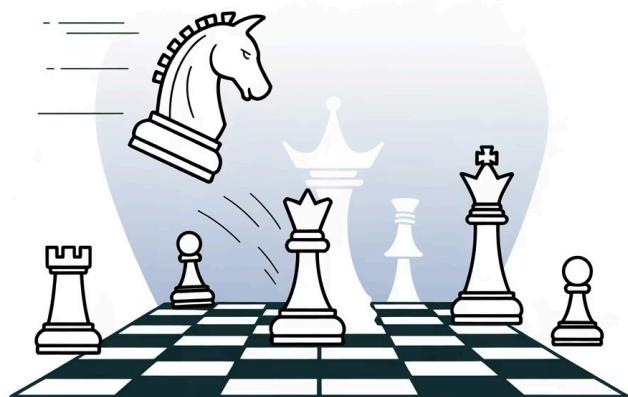
## Passive for Core

Employ index funds selectively for stable, core portfolio exposure to established sectors and large-cap stocks.

This hybrid approach allows investors to capture the cost advantages of passive strategies for core holdings while still benefiting from active management's potential to add alpha in segments where skill and research can create value. It's about being strategic rather than dogmatic.

Consider starting with a 60-40 or 70-30 split between active and passive strategies, adjusting based on your conviction in active managers, market conditions, and personal risk appetite. The key is to make informed decisions rather than following the crowd.

# Conclusion: Don't Fall for the Passive Trap



Index funds are not a magic bullet for Indian investors chasing growth. They're a tool—useful in specific contexts but dangerous when applied blindly as a one-size-fits-all solution.

The passive investing narrative that dominates global financial media is built on assumptions that don't hold in Indian markets. Our markets are different: more volatile, less efficient, and full of opportunities that passive strategies systematically ignore.

## India's Market Reality

Dynamic, inefficient markets reward active management and punish passive complacency. Don't ignore this fundamental difference.

## Your Portfolio Deserves Better

Settling for market returns when superior risk-adjusted returns are available is a disservice to your financial goals.

## Think for Yourself

Question popular trends, especially when they originate from markets with completely different characteristics than India.

**Fight the herd mentality. Demand active management where it counts. Your portfolio deserves more than just "market returns."**

Blindly following global investment trends without considering India's unique market dynamics and your personal investment aspirations is a recipe for mediocrity. Be smarter. Be more demanding. And most importantly, don't let the passive investing crowd convince you that average returns are good enough.