Shrinking alpha
Active versus passive investing in the Indian mutual funds industry
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Executive summary

The performance of actively managed funds has come under the spotlight as an increasing number of these funds have failed to beat market benchmarks in recent years.

Meanwhile, we have seen a sharp surge in assets of passive funds in the country, up nearly five times in the past five years, due to adoption of passive strategy by large institutional investors such as provident fund (PF) trusts.

Is the recent underperformance of actively managed funds a new phenomenon or have we seen it before? What were some of the reasons that affected performance of actively managed funds? Will this recent underperformance of actively managed funds push individuals towards passive funds? What is in it for the distributor community, who are already hard pressed for income due to declining expense ratios for mutual funds in the country?

We try to find answers to such pertinent questions in this white paper, which evaluates the performance of actively managed funds by analysing their long-term historical performance and looks at what lies ahead.

It also incorporates the views and learnings gleaned from industry leaders during two interactive webinars held with the independent financial advisor (IFA) community on May 18 and June 10, and also showcases the results of a survey conducted by CRISIL with IFAs on the topic.
The rise and rise of passive fund management

Passively managed funds have emerged as a force to reckon with globally in the past decade. The category is estimated to have accounted for ~31% of the assets of open-ended mutual funds worldwide as of 2020. In developed markets such as the United States (US), it constituted 40% of the country’s mutual fund assets, again more than double its share a decade ago.

Global share of passive funds

[Image showing global and US share of passive funds]

In India, too, the share of passive funds in mutual fund assets has grown exponentially in recent years. This, however, has been on a low base. Despite a history of over two decades in India, growth in passive fund assets has picked up only in the past five years. The investments have been led by provident fund (PF) trusts, which were allowed to invest in equity in 2015. Most PFs chose to invest in the equity market through the exchange traded fund (ETF) route. Employees’ Provident Fund Organisation (EPFO), which is the largest PF in India, decided to invest 5% of its annual accretion in equities through ETFs. Subsequently in fiscal 2018, EPFO increased its allocation to 15% of its annual accretion i.e. the full amount available, through this route.

The government’s decision to opt for the ETF route to divest its stake in public sector enterprises (PSE) has provided another major push to passive funds in the country. The Bharat 22 ETF, the Central Public Sector Enterprises (CPSE) ETF, and the recent Bharat Bond ETF are some of the major launches that have paved the way for the segment’s growth.

Source: Statista, ICI
Evolution of the passive funds industry in India

Uniform categorisation by the Securities Exchange Board of India (SEBI) is another key factor that has propelled the growth of passive products, albeit indirectly. While the regulator has capped the number of funds per fund house at one in the standard categories, the rule does not apply to passive funds (ETFs/ index funds), fund of funds (FoFs) and sectoral/ thematic funds, thus leaving it open for asset management companies (AMCs) to launch products in these categories. Indeed, since 2018, funds launched in the passive space, including ETFs, index funds and FoFs linked to a single ETF totalled 79, much more than the 50 funds launched in actively managed equity mutual funds¹.

With money being pumped into the passive funds segment and the launch of products in this space, the product range has grown exponentially. From a few products spread across a limited range of options, the category has expanded to more than 150 funds investing in equity, debt, gold and international asset classes.

¹ Data for January 2018 – May 2021
Passive funds provide exposure across asset classes and segments

Types of passive funds

- **Equity**
  - Market cap ETFs such as Nifty 50, Nifty 100, etc.
    - AUM Rs 210,428 crore | 47 ETFs / 35 index funds
  - Sectoral ETFs that track specific sectors or themes
    - AUM Rs 27,020 crore | 25 ETFs
  - Other ETFs such as CPSE ETF, smart beta strategies
    - AUM Rs 13,890 crore | 6 ETFs

- **Debt**
  - Invests in debt benchmarks / government disinvestment initiatives
    - AUM Rs 35,836 crore | 11 ETFs / 4 index funds

- **Gold**
  - Tracks gold prices and invests in bullion
    - AUM Rs 14,123 crore | 11 ETFs

- **International**
  - Invests in global indices such as Hang Seng, Nasdaq, etc.
    - AUM Rs 3,538 crore | 2 ETFs / 4 index funds

Source: AMFI, CRISIL Research

Assets and scheme information data as of March 2021

The above chart does not include fund of funds investing in ETFs and index funds
Underperformance of active funds a reality

Over the years, the markets have become more efficient due to a number of regulatory reforms undertaken by SEBI, besides greater transparency, growth in market participants, and wider research coverage. This means finding ways to beat the market is becoming increasingly difficult, making it a challenge to generate alpha consistently.

CRISIL analysed the historical performance of actively managed equity funds in India.

Study on the historical average alpha of equity mutual funds

To delve deep into performance, CRISIL classified this analysis into the three major market variants of equity mutual funds in the country – large-cap, mid-cap and small-cap funds.

To analyse performance, CRISIL constructed a composite performance index of the respective fund categories, using asset-weighted returns of underlying funds ranked under the quarterly CRISIL Mutual Fund Ranking.

Instead of static point-to-point returns, rolling returns on a daily basis for a 5-year investment horizon were analysed across these fund categories (since inception) and across market cycles.

The Nifty 50 TRI, Nifty Mid-cap 100 TRI and Nifty Small-cap 100 TRI were considered for performance comparison. These benchmarks were identified based on their majority share of usage within the respective category of mutual funds.

In another study, CRISIL also identified the proportion of funds within large, mid- and small-cap funds outperforming their benchmarks historically. In this study, the shift in five-year rolling returns has been considered on an annual basis.

Five-year rolling average alpha of major equity-oriented mutual fund categories

Source: CRISIL Research

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2 For the period prior to the introduction of the category in CRISIL Mutual Fund Ranking, the index values have been calculated using the NAVs of the funds that formed part of the respective category at the time of its introduction into CMFR.
The inferences

- The analysis shows that underperformance of active funds is a reality, though there is variation in terms of the numbers
  - Underperformance is more evident in large-cap mutual funds, even as the mid- and small-caps have gravitated towards lower outperformance
- The underperformance of large-cap funds has become more evident after re-categorisation of schemes in 2018, limiting their investment in lower capitalisation stocks to less than 20% of the portfolio, while minimum 80% of the portfolio has to be invested in 100 large-cap stocks defined by AMFI
  - Prior to the re-categorisation, there was no cap on capitalisation of stock holding, thus giving these funds more flexibility to invest in lower capitalisation stocks
  - The limited universe of 100 large-cap stocks, skewed positive performance of some major companies in the segment, funds underweight to top performing stocks in the large-cap universe and the inability of the fund manager to replicate the index weights of such companies due to exposure limits could be impacting the performance of large-cap funds
  - For instance, Reliance Industries has been a top 10 performer in the three years ended March 2021. It gave 29% compound annual returns in the period compared with ~12% for Nifty 100 to emerge as one of the top five performers on the index. The exposure of this stock to large-cap funds in this period has been 4.41% compared with a weight of nearly 10.2% for the stock in the index
  - Meanwhile in the case of HDFC Bank, while the average holding by large cap funds of the stock was 8.3%, the index weight of the stock stood at 10.4% in the past three-year period
  - Similarly, other performing heavyweight stocks such as HDFC and TCS also had lower exposure in large-cap funds in this period
  - The results of the survey conducted with IFAs also highlighted this narrow breadth of performance in recent years. This, coupled with the inability of the fund manager to replicate those stocks in their portfolio, are some of the major factors for the underperformance of actively managed equity funds, especially in the large-cap space
- Mid-cap funds had a negative start to their alpha generation in the five-year rolling return analysis carried out since it also coincided with the sharp downturn during the Global Financial Crisis of 2008
  - After that, they have been able to generate positive returns versus their benchmarks, though in recent times, the alpha on returns have trended downwards
- Small-cap funds have a relatively shorter history of just about more than a decade and in the five-year rolling return analysis have been able to generate better alpha versus their benchmarks
  - The large number of securities available within the small-cap space also provide a wide array of investment options, thus benefitting fund management in the space

Meanwhile, a side study done on the proportion of funds outperforming the benchmark corroborated the findings of the main study. The findings:

- Among the mutual fund categories analysed, large-cap funds have the highest proportion of funds
underperforming the benchmark, while small-caps have the highest proportion of funds outperforming the benchmark

- The share of large-cap funds underperforming the benchmark has grown in recent years with nearly 90% of the schemes in the category generating negative alpha in the latest five-year rolling period ended March 2021

- Mirroring the inferences from the first study, a large share of mid-cap funds underperformed the category benchmark in the initial few years of analysis, generating alpha later, with recent years again seeing an increasing number of the category funds underperforming the benchmark

- Small-cap funds have generally outperformed their benchmark over the period analysed, with only a small share giving negative alpha in the latest five-year rolling period ended March 2021

**Outperformance of large-cap funds versus Nifty 50 TRI, 5-year returns**

**Outperformance of mid-cap funds versus Nifty Midcap 100 TRI, 5-year returns**
Outperformance of small-cap funds versus Nifty Small Cap 100 TRI, 5-year returns

Our analysis – that actively managed funds tend to lag benchmarks during bull phases and perform well during the bear phase – is corroborated by the IFA community and industry leaders.

Market phase analysis – Higher outperformance seen in bear phase

Since the turn of the century, bull and bear phases of markets have been used for performance analysis of respective fund categories based on their history.

CRISIL did a market phase analysis study to identify the alpha generated by actively managed funds during the bull and bear phases of equity markets.

The inferences:

- Market phase analysis shows actively managed funds tend to outperform their benchmark more during bear phases compared with bull phases
  - Fund managers tend to play catch up to the market during secular bull runs
  - However, during bear phases, actively managed funds fared better
- Large-cap funds outperformed the benchmark in three out of five bull phases, while they generated alpha in four out of six bear phases
- Mid-cap funds gave negative alpha compared with the benchmark in two out of four bull phases, while they outperformed in three out of five bear phases
- Small-cap funds generated alpha in all of the four bear phases and gave positive alpha in two out of the three bull phases.
How the categories moved in different market phases

Large cap

Recovery from Covid-19 (Mar-20 - Mar-21)
Covid-19 crisis (Feb-20 - Mar-20)
Tight liquidity in lending sector (Aug-18 - Feb-20)
Liquidity and reforms-driven rally (Mar-16 - Aug-18)
Chinese slowdown (Mar-15 - Feb-16)
Post European crisis (Dec-11 - Feb-15)
European crisis (Nov-10 - Dec-11)
Post sub-prime crisis (Mar-09 - Nov-10)
Sub-prime crisis (Jan-08 - Mar-09)
Bull phase (Apr-03 - Jan-08)
Tech bubble burst (Apr-00 - Sep-01)

Mid-cap

Recovery from Covid-19 (Mar-20 - Mar-21)
Covid-19 crisis (Feb-20 - Mar-20)
Tight liquidity in lending sector (Aug-18 - Feb-20)
Liquidity and reforms-driven rally (Mar-16 - Aug-18)
Chinese slowdown (Mar-15 - Feb-16)
Post European crisis (Dec-11 - Feb-15)
European crisis (Nov-10 - Dec-11)
Post sub-prime crisis (Mar-09 - Nov-10)
Sub-prime crisis (Jan-08 - Mar-09)
Bull phase (Apr-03 - Jan-08)
Tech bubble burst (Apr-00 - Sep-01)

Small cap

Recovery from Covid-19 (Mar-20 - Mar-21)
Covid-19 crisis (Feb-20 - Mar-20)
Tight liquidity in lending sector (Aug-18 - Feb-20)
Liquidity and reforms-driven rally (Mar-16 - Aug-18)
Chinese slowdown (Mar-15 - Feb-16)
Post European crisis (Dec-11 - Feb-15)
European crisis (Nov-10 - Dec-11)
Post sub-prime crisis (Mar-09 - Nov-10)
Sub-prime crisis (Jan-08 - Mar-09)
Bull phase (Apr-03 - Jan-08)
Tech bubble burst (Apr-00 - Sep-01)

Source: CRISIL Research
Most industry experts feel judging actively managed funds over one market cycle is not optimum. Instead, the performance of actively managed funds should be assessed across multiple markets over long periods of time to gauge their efficacy.

To test whether a longer investment horizon improves the performance of actively managed funds versus benchmarks, CRISIL conducted a study.

**Longer horizon key to alpha generation as well**

The study was aimed at checking the efficacy of the longer investment horizon in actively managed equity funds to generate alpha versus benchmarks. Distribution of daily rolling alpha of large-cap, mid-cap and small-cap funds was analysed over the short term (one year) and long term (five years). The common period between April 2010 and March 2021 was considered for analysis.

**The inferences**

- The study shows a longer investment horizon tilts the alpha towards the positive zone.
- The range of negative alpha also reduces considerably as the investment horizon increases.
  - The extent of average underperformance reduces from 31% for a one-year investment horizon to 3% for a five-year investment horizon.
- While there are instances when the average performance of large-cap and mid-cap funds are lower than the benchmark index even in a five-year rolling period, the average alpha of small-cap funds is positive on all the instances for a longer investment horizon.

**Distribution of returns over short and long investment horizons**

*Source: CRISIL Research*
Thus, investment horizon plays an important role in adding efficacy to the investor’s portfolio.

Another important facet of successful mutual fund investment is prudent scheme selection. This is because of the dispersion seen in the performance of actively managed funds, as corroborated by our analysis.

**Fund selection also plays a major role in outperformance**

The study was aimed at checking the efficacy of fund selection in actively managed equity funds to generate alpha versus benchmarks. Dispersion of alpha across funds within the category for a five-year investment horizon was reviewed on an annual basis.

The inferences:

- Stark divergence is seen in the best and worst funds in all categories of mutual funds
- While most small-cap funds have generated positive returns versus the benchmark, except in the latest five-year rolling period, there is variation in returns between the top and the worst performers in the category. This indicates that an investor who does not choose the right fund might end up with deficient alpha
- To address this, prudent scheme selection is imperative
- The survey results of IFA also show right fund selection as the key factor that can increase the possibility of actively managed funds to outperform

**Alpha of large-cap funds over a five-year period**
Alpha of mid-cap funds over a five-year period

Alpha of small-cap funds over a five-year period

Funds which are shortlisted in CRISIL Mutual Fund Ranking are considered for analysis.

Source: CRISIL Research
Role of intermediaries in fund selection and beyond

Intermediaries have played a major role in the mutual fund industry’s development in the country, especially as investment planning used to historically revolve around traditional fixed income instruments. Their role today goes beyond acting as a facilitator between investors and asset managers.

Role of intermediaries

Goal-based financial planning – Intermediaries have to enable holistic portfolio planning based on individual goals and the risk-return profile of the investors instead of looking at short-sighted opportunity-based investments.

Asset allocation – Prudent asset allocation based on the investor’s risk-return profile and investment horizon not only enables efficient investment selection but also reduces volatility associated with the capital markets. Intermediaries can use passively managed funds across asset classes to construct a diversified portfolio for investors.

Guidance during market volatility – An intermediary’s role goes beyond traditional investment planning to handholding and guiding investors during volatile market conditions. For instance, intermediaries can play a vital role in helping investors tide over difficult phases such as the sharp correction following the GFC in 2008 and disruptions after the onset of the Covid-19 pandemic in March 2020.
Prudent scheme selection – Recommendations to investors should look beyond point-to-point returns and evolve into a more scientific approach that involves periodic interactions with the fund manager to understand the investment strategy. In quantitative analytics, factors such as consistent risk-adjusted performance across market phases, analysis of inherent risk in the portfolio among others should be considered for scheme selection. Advisors can additionally refer to mutual fund rankings released by independent third-party agencies to shortlist schemes.

Investor behaviour – It is also important to understand investor preference before making investment decisions. For instance, investors seeking returns in line with the broad market performance are better off with passively managed funds within the fund universe, while those seeking returns in excess of benchmark indices are better off with actively managed funds.

Set realistic return expectations – Investors tend to get influenced by sharp market movements, especially the uptrends. However, equity returns have moderated from 15-20% historically over the long term to 12-14% in recent years. Hence, the advisor should align the expectations of investors to the realistic performance of different asset classes, thereby improving the possibility of meeting their financial goals.

Robo-advisory – peaceful co-existence with IFA

This is a growing segment in the intermediary landscape, buoyed by technological advancements and growth of do-it-yourself (DIY) investors in the country. These firms can enable faster penetration of the products and services in the hinterland through technology. However, they could co-exist with the regular advisory community as their target segments vary. While advisors guide investors in personal, robo-advisors could support more mature investors.

Sufficient incentives to intermediaries is a key enabler for them to promote products across the active and passive mutual funds space. Further, tax incentives such as 401K for retirement planning in the US could support the mutual funds industry and distributors while also providing an additional impetus to investors. Adding financial planning and advisory training to the education curriculum can support growth of the mutual fund distributor community like the insurance distribution community in India.
Side note – Passive debt investment, an emerging segment

Actively managed equity mutual funds have drawn a lot of attention in recent years both in terms of money flows and their performance.

Passive debt funds, still in a nascent stage in India, got a large boost after the launch of Bharat Bond ETF. Bharat Bond ETF accounts for over 80% of the debt passive space and is used by the government to fund CPSE and PSE companies by creating a bond portfolio across three maturity buckets, thereby providing conservative investors another investment avenue. The success of Bharat Bond ETF has inspired other fund houses to launch similar passively managed debt funds; however, these funds are limited to the highly liquid sovereign issuance space.

In terms of performance, CRISIL’s analysis shows that most actively managed debt funds have underperformed their benchmark in the recent three-year period.

- As highlighted in the table below, only two categories had more than 50% of the funds outperforming their benchmark indices.

<table>
<thead>
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<th>% of funds that outperformed the benchmark in a category</th>
<th>0%</th>
<th>1% to 25%</th>
<th>26% to 50%</th>
<th>51% to 60%</th>
<th>60%+</th>
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</thead>
<tbody>
<tr>
<td>Number of categories</td>
<td>3</td>
<td>4</td>
<td>3</td>
<td>2</td>
<td>0</td>
</tr>
</tbody>
</table>

Funds which are shortlisted in CRISIL Mutual Fund Ranking are considered for analysis.

Source: CRISIL Research

Funds in the passive space present an active opportunity to develop the debt market by funneling funds of foreign portfolio investors (FPIs). However, it is a complex task and the challenges and proposed solutions are outlined below.

<table>
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<th>Challenges</th>
<th>Solution</th>
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<tr>
<td>Low secondary market liquidity for corporate bonds</td>
<td>Improve presence of market makers and set up institutions to enhance liquidity of investment grade bonds</td>
</tr>
<tr>
<td>Replicating the index is a challenge due to the illiquid nature of the bond market</td>
<td>Relaxation of replication norms</td>
</tr>
<tr>
<td>Lack of awareness</td>
<td>Initiatives to drive investor awareness</td>
</tr>
</tbody>
</table>
A calibrated approach imperative for growth of passive funds in India

Passive funds have registered impressive growth in the global fund management industry; however, some perils in the fund investment strategy need to be addressed.

The foremost issue is the potential concentration of flows compared with actively managed funds. For instance, as per data from the Investment Company Institute in the US, index domestic equity mutual funds and ETFs received $1.8 trillion in net new cash and reinvested dividends from 2010 through 2019, while actively managed domestic equity mutual funds experienced a net outflow of $1.7 trillion (including reinvested dividends).

Inflow and outflow of the US mutual fund industry

This concentrated flow of money into a specific segment of the market further accentuates industry concentration and allocation of money is especially skewed towards market cap-based indices.

Further, passive investing by design requires investors to take exposure to stocks that may not be favourable in a given market condition.
The share of the Indian passive funds management industry is still relatively small in terms of the overall industry, with adoption primarily restricted to institutional investors. The recent underperformance of actively managed equity funds, especially large-cap funds, therefore, presents a case for passive funds in the portfolio. Investors can opt between index funds and ETFs based on their preference. Investors can look at adding passive managed funds as part of their overall portfolio depending on their preferences, risk profile and key investment goals.
Annexure

IFA survey results (based on 132 respondents)

Demographics of the survey respondents

AUM (in Rs) range of respondents

- Less than 50 Lakhs: 23%
- 50 Lakhs to 1 Crore: 5%
- 1 Crore to 50 Crores: 59%
- 50 Crores to 100 Crores: 4%
- 100 Crores and above: 9%
What has been the most important factor for actively managed funds' underperformance to their benchmark?

A majority of IFAs (55) feel the narrow breadth of market performance is to blame for the underperformance of actively managed funds.
What are the key factors that can increase the possibility of actively managed funds outperforming their benchmark?

Among the factors analysed by CRISIL, the survey results show that most IFAs (54) feel that prudent fund selection can increase the possibility of actively managed funds outperforming their benchmarks.

According to you, which category among the following actively managed equity funds is expected to generate highest alpha over the benchmark?

Survey results show that IFAs believe that mid-cap and small-cap mutual fund categories will generate the highest alpha over the benchmark. The results are in line with CRISIL’s analysis of the historical performance trends of these mutual fund categories.
Are you advising passive funds as part of wealth planning to your investors?

Based on the survey response, IFAs advising passive funds as part of wealth planning to their investors have a slightly higher share compared with the ones who do not. Further, within the IFA space, the ones with lower AUM show a higher inclination towards passive funds.

How do you position passive funds in the overall portfolio allocation of your investors?

While a majority of respondents were non-committal on their allocation, most did see passive funds as a core allocation followed by those viewing them as a satellite allocation.
Do you think passively managed debt funds should be part of an investor's debt portfolio?

Over 60% of the respondents felt that passively managed debt funds should be part of an investor’s debt portfolio. With the government raising the ante on divestment through the debt ETF route, along with multiple product launches in the passive debt mutual fund space, we could see higher participation by investors in this space.

What percentage of an investor’s portfolio do you allocate to passive funds?

Nearly 75% of the respondents allocate their investor’s portfolio towards passive funds with a small minority investing up to 30% of the portfolio towards index funds/ETFs.
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