ETF Industry Perspectives Q1 2025

Know what you own in 2025

Vanguard ETF Industry Perspectives is our quarterly in-depth commentary, with analysis of key trends and how they're affecting ETF investors.

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Key highlights

- **Equity spotlight:** India looms large in the current global economy. Its population, unlike those of many other countries with important economies, is growing. Just as importantly, India's GDP has been rising along with that population growth. But there are implications for international investors to consider: Capital gains taxes in India are misunderstood and underestimated. Our dive into the world of Indian equities will potentially help investors better understand the distinction between what you see and what you get.

- **Fixed income spotlight:** Amid perceptions that some investors may be overallocated to cash, we're taking a closer look at what the reality is. Investors hold cash to be able to fund nearer-term needs with a highly liquid asset. But it turns out that investors could allocate to other assets that might generate more yield than cash without adding significant volatility or giving up too much liquidity—including ultrashort bond ETFs.

Remember how India's capital gains taxes affect index ETFs

Amid widening geopolitical and economic uncertainty, Indian equities loom large as a market with robust growth that has boosted the prominence of India in global equity indexes and rewarded investors with often-solid returns.

India's growing population of 1.43 billion enabled it to recently surpass China as the most populous country in the world.[1] Additionally, India's GDP has been growing sharply, rising to $3.55 trillion at the end of 2023 from around $300 billion in 1990, just before the end of the Cold War.[2]

India's stock market has reflected this growth, with a record 233 initial public offerings in 2024.[3] Moreover, the weighting of India in international stock indexes has grown along with investor interest. Consider the following evidence of India's rising prominence, as reflected by changing exposure for Vanguard ETFs:

- India now makes up more than 20% of Vanguard FTSE Emerging Markets ETF (VWO)—about double its percentage from half a decade ago.[4]
- Additionally, India now composes about 6% of Vanguard Total International Stock ETF (VXUS)—again, approximately doubling its percentage over that time frame.[5]

Be aware of high capital gains taxes

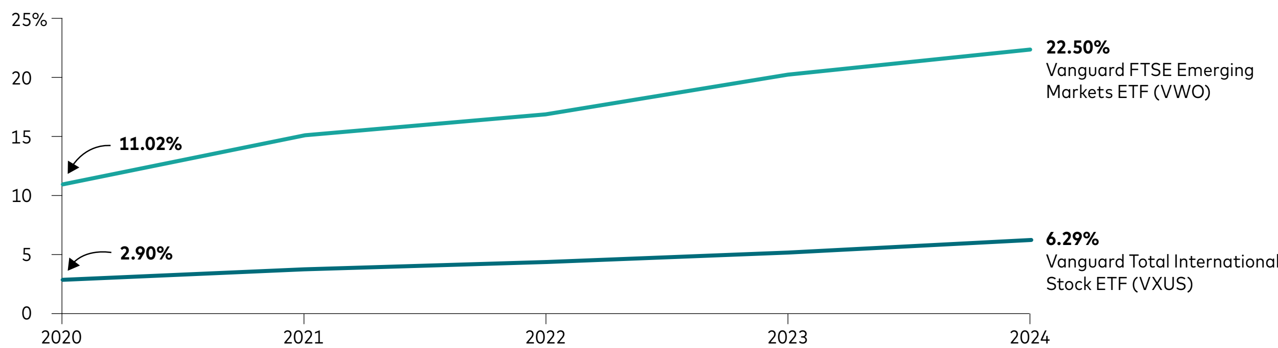
The catch is that India has a capital gains tax of 12.5% per year—a relatively high rate that can surprise investors who don't understand how the taxes impact performance.[6]

Taxes on unrealized capital gains are accrued daily on Indian securities even though taxes aren't realized until securities are sold, and indexes don't take such taxation into account. This results in two key considerations:

- Investors may not track Indian market performance closely because ETFs are accounting for the impact of the taxes, while indexes aren't.
- Worse, the tracking error for emerging markets ETFs becomes greater in proportion with the percentage that India composes in respective indexes.

But armed with key knowledge, investors can potentially take great advantage of one of the world's most promising equity markets without any rude awakenings.

Percentages of VXUS and VWO allocated to India



Source: Morningstar, Inc., as of November 30, 2024.

1 World Bank, as of December 31, 2023.
2 World Bank, from December 31, 1990, through December 31, 2023.
3 Morningstar, Inc., as of October 31, 2024.
4 Morningstar, Inc., as of November 30, 2024.
5 Morningstar, Inc., as of November 30, 2024.
6 Morningstar, Inc., as of November 30, 2024.

Is too much cash really on the sidelines?

Cash has been accumulating in recent years, with money market assets growing from $3.6 trillion in 2019 just before the pandemic to $6.7 trillion by the end of 2024.[7] This has led some observers to suggest investors are sitting on too much cash that ought to be more strategically allocated.

While the increase in cash is substantial and the risks of cash overallocation are real, there's another truth: The percentage of overall investor allocations to cash relative to other assets has remained largely unchanged over the past few decades.

The more nuanced truth is that while cash allocations have spiked briefly in recent history due to the dot-com bust, global financial crisis, and COVID-19 lockdown, the amount that investors allocate to cash has been averaging around 24% of total allocations since 1993, as the next chart shows.

Additionally, cash allocations have largely remained steady over the past five years, apart from the pandemic-influenced spike in 2020. Allocations by percentage to equities and fixed income have likewise been remarkably consistent during that time, even as total assets invested have increased.[8]

Reassessing cash allocations

With uncertainty surrounding interest rates, now is a good time to look closely at how much cash clients hold and why. Is it too much, too little, or just the right amount?

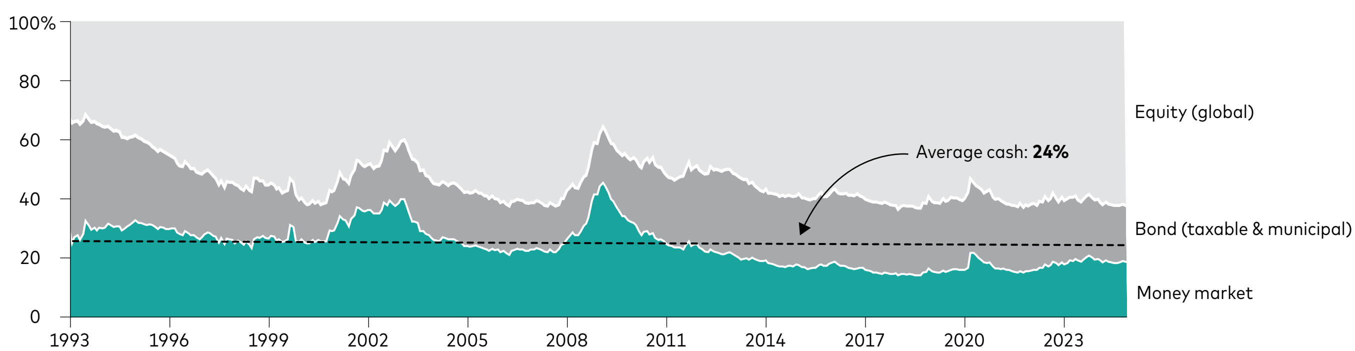
For starters, it's crucial to assess how much your clients anticipate needing to spend for basic needs. An ample capacity to fund such considerations mixed with a lower risk tolerance could mean that less cash is needed.

If an investor holds more cash than necessary in the short term, they could invest in ultrashort bond ETFs for potential extra yield without sacrificing liquidity. Alternatively, if an investor is underallocated and more concerned with funding future spending needs, they might consider equities or longer-dated bond investments to lock in higher rates.

Holding cash to help lower volatility and protect principal can make sense. However, if liquidity is a greater concern, the ETF structure's benefits can help optimize a portfolio, especially regarding ultrashort bonds. The liquidity of ETFs has helped make it easier to hold bonds and sell them when cash is needed, without incurring large fees or steep discounts to unload them.

So, whether clients hold more or less cash than the 20%-plus allocation that has prevailed over the past 30-plus years, ensure that the cash allocation serves a clear purpose.

U.S. investor allocations to cash since 1993



Notes: The chart depicts sector allocations of U.S. investors from 1993 through 2024.
Source: Morningstar, Inc., from January 31, 1993, through November 30, 2024.

7 Morningstar, Inc., from November 30, 2019, through December 31, 2024.

8 Vanguard, based on data from Morningstar, Inc., from January 31, 1993, through November 30, 2024.

Important information

For more information about Vanguard funds or ETF Shares, contact your financial advisor to obtain a prospectus or, if available, a summary prospectus. Investment objectives, risks, charges, expenses, and other important information are contained in the prospectus; read and consider it carefully before investing.

Vanguard ETF Shares are not redeemable with the issuing Fund other than in very large aggregations worth millions of dollars. Instead, investors must buy and sell Vanguard ETF Shares in the secondary market and hold those shares in a brokerage account. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

All investing is subject to risk, including the possible loss of the money you invest.

Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.

Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks.

U.S. government backing of Treasury or agency securities applies only to the underlying securities and does not prevent share-price fluctuations. Unlike stocks and bonds, U.S. Treasury bills are guaranteed as to the timely payment of principal and interest.

Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. Diversification does not ensure a profit or protect against a loss.

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