

A case for Indian Equities in Global Portfolios

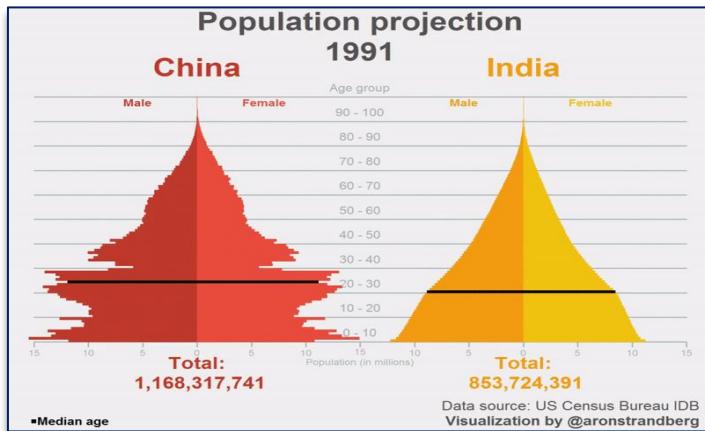


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India Avenue Investment Management
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Inclusion of Indian Equities in a Global Portfolio

India is likely to be fastest growing economy amongst major economies during the 2020's according to IMF, World Bank and other independent agencies. The country's growth is being driven by unique demographics, which illustrate a youthful and significant population approaching a low point in its dependency ratio over the next two decades.

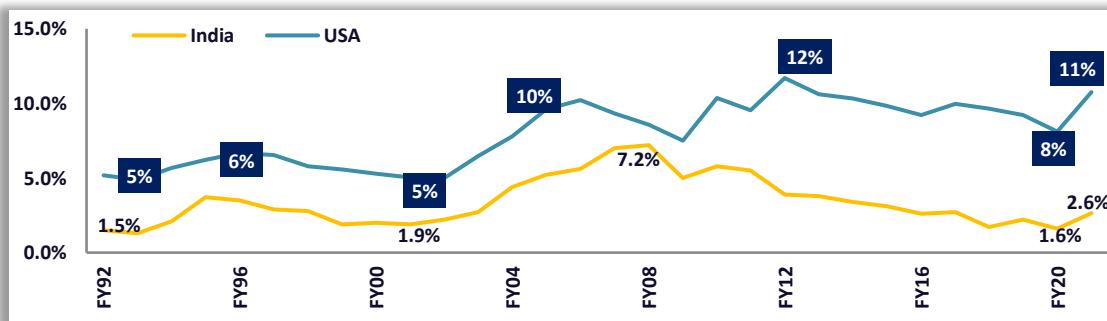


Most investment portfolios in Australia have less than 1% weight to India, achieved through large-cap oriented EM/Asia funds – Yet India is already 3% of global GDP and close to 3% of global market capitalisation.

We are of the view that timing for an India specific allocation is appropriate given the following:

1. Reforms undertaken by the Modi Government since winning office in 2014 are likely to be at their most productive going forward, after a "J-curve"
2. The cost of capital has fallen, and this is a lead indicator of the next business cycle commencing in India. During the last cycle, earnings growth was above 20% p.a.
3. India's exports will benefit from an increased focus on manufacturing, global partnerships and the **China + 1 strategy** adopted by those seeking to diversify their global supply chains
4. India's equity markets exhibit **low correlation to AUD based assets**, making it an attractive inclusion in a global equity portfolio, given the sustainability of its growth profile.
5. India is **close to the bottom of its earnings cycle**, relative to other regions. Corporates have significant operating leverage to an economic recovery, which is now underway.

Chart 1: India vs US Corporate Profit to GDP – bottom of cycle vs top of cycle (Source: Spark Capital, India)



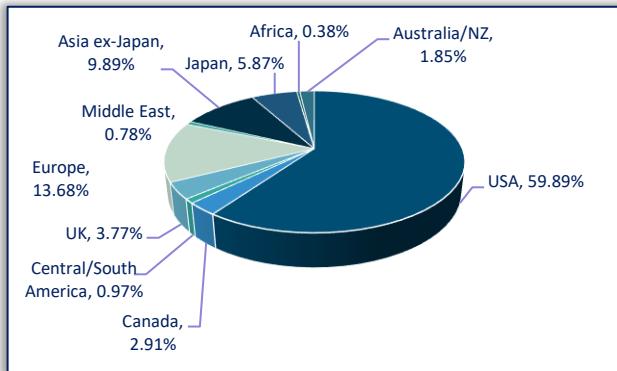
Today, most Australian institutional investors typically hold exposure of 3-10% to Emerging Market/Asia Funds in their higher risk profile portfolios (Balanced, Growth, High Growth).

It is our view that these investments are held for the purposes of **superior growth** (emerging economies are forecast to grow at a faster pace than developed economies) and **diversity** (local fundamentals are unique relative to more mature economies).

It is with reference to these needs that we identify as a direct allocation to India in global equity portfolios, challenging the logic of the traditional implementation.

Initially, as part of our analysis we analyse the hurdle for institutional investors. Typically, most “benchmark” their global equity portfolios to the MSCI All Country World Index.

Chart 2 – MSCI ACWI August 2021

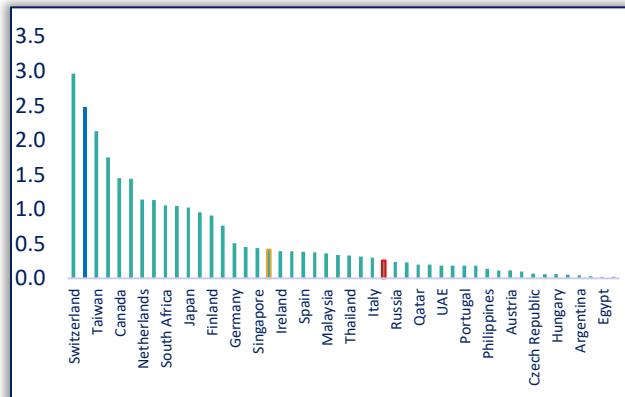


Source: MSCI ACWI ETF

The dominance of the US equity market is clear given:

- the strength of its equity market post GFC
- several foreign businesses choosing to list in the US to attract capital/funding; and
- US businesses generate significant offshore revenue and are largely global in nature.

Chart 3 – ACWI Weight / GDP Share



Source: India Avenue Research, Statista.
Orange bar = India, Red bar = China, Blue bar = US

Relative to global GDP share, regions like Switzerland, USA, Taiwan, the Nordics and other select countries equity markets are dominant. Over very long-term periods these should generally be cyclical as economies rise and fall, over decades/centuries. However, this relationship has struggled to hold true in the face of globalization, with revenue bases becoming less aligned to a company's country of domicile.

Another interesting point to note is the breadth of individual country markets. Markets like the US, Japan, UK, Canada, France, Germany, India, and China are deeper (as measured by investable stocks) than other markets where there are a few large dominant companies (Samsung in South Korea, Taiwan Semi in Taiwan, Nestle, Roche and Novartis in Switzerland). Only 11 markets have over 50 stocks in the MSCI ACWI (USA, China, Japan, Canada, UK, India, South Korea, Taiwan, France, Australia, and Germany).

The linkage to share of global GDP is the connection to a rising opportunity set available to investors over time as an economy is privatised, liberalised, or opened. Today that is one of the arguments from increasing portfolio exposure to China as its stock market increasingly opens to foreign investment.

Is GDP Growth correlated to Equity Market Returns?

In 2005 a well-known study by Dimson, Marsh and Staunton, covering 53 countries and over 100 years of data, concluded that there was no stable positive long-term relationship between GDP growth and equity returns – in fact the relationship was negative!

However, a further study in 2012 indicated that there was a significant relationship between equity returns and forecasted/expected GDP growth¹, which makes sense given the discounting mechanism which equity markets can be.

The Case for China

Investors seek to include investments in a portfolio which are additive from a risk-return perspective. Too often investments are considered for their stand-alone characteristics, rather than their contribution to improving a portfolio. This is linked to trying to replace components without understanding the balance of the overall construct.

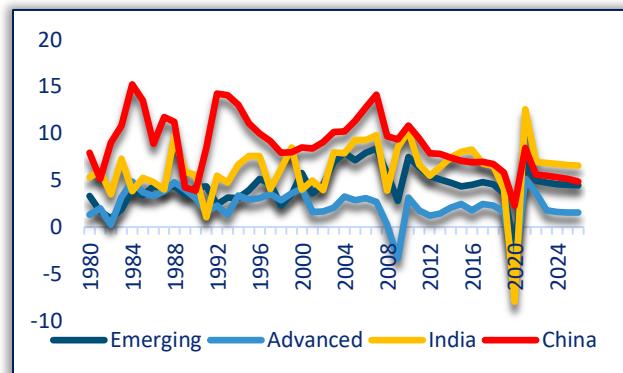
Most global equity investors anchor their construction thought process to a benchmark as slippage against this hurdle is how they perceive risk. The case being made today for single country China allocations is occurring due to China increasing weight in the benchmark (5%) as its A-Share market is increasingly included in the MSCI ACWI. However, the case should have been obvious a decade ago due to China's increasing presence in the global economy and the rise and accessibility of its capital markets.

Looking forward, it appears feasible to consider an “overweight” position in a global equity portfolio to China, based on the following:

- GDP growth > Developed Markets
- Increasing size and inclusion of China's capital markets
- Shift from manufacturing to consumption adding diversity for foreign investors
- Potential for a rising currency

Additionally, the implementation method should favour locally domiciled, highly credentialled fund managers, who understand the local ecosystem and the broader market opportunity set, rather than those domiciled in global centres, trying to participate only in the most large and liquid companies.

Chart 4 – China & India > GDP growth of Advanced and Emerging Economies



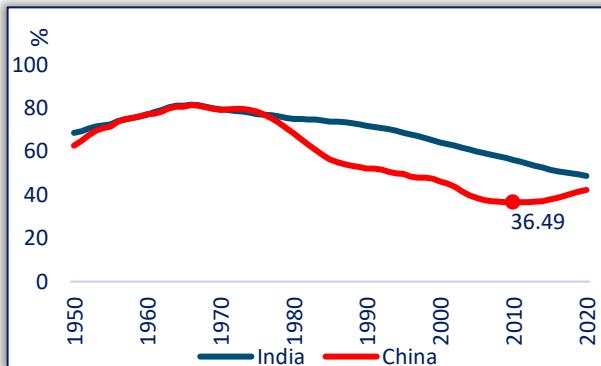
Source: WEO Handbook April 2021

Don't forget India

The IMF continues to forecast two economies to drive a significant share of incremental growth, being China and India. China's low dependency ratio drove its productivity from 1980-2020 and over the next decade its growth should trend towards emerging economies growth rate given its higher established GDP base.

¹ O'Neill, Stupnytska & Wrisdale (2011). Linking GDP Growth and Equity Returns. GSAM

Chart 5 – China & India's Dependency Ratio



Source: Statista

China has now handed the baton of world's fastest growing major economy to India. The dependency ratio of India is dropping like the dip experienced by China's from 1980 to 2010 and aligned to a faster period of economic growth.

Why India?

We feel there is a strong case for inclusion of an India specific allocation, alongside a China allocation. We base this case on the following points:

- India will experience strong GDP growth over the next two decades as its dependency ratio reaches its bottom.
- Indian equities correlation to AUD based assets is significantly lower than Emerging Markets, making it a more attractive asset for Australian investors than Emerging Markets i.e., higher growth profile, and improvement in portfolio diversification and hence lowering risk (contrary to common belief).

Chart 6 – India's correlation to ASX200 and MSCI World relative to EM correlations



Source: MSCI, India Avenue Research

- Reforms undertaken by the Modi Government since 2014 are likely to be impactful and productive over the next decade and will result in the rise of GDP-per-capita.
- India's focus on value-added manufacturing and low-cost labour structural arbitrage will allow it to participate in any China +1 discussions and thereby increase its importance in global supply chains. Exports in India are likely to rise from US\$300bn per annum to closer to US\$1trillion per annum by 2030 if this occurs. This will lead to significant productivity gains and operating leverage.
- The lower cost of capital and abundant liquidity in the system is likely to lead to the next business cycle, which has been delayed over the last decade due to lack of capital, high cost of capital and lack of demand (apart from consumption and credit). During the last business cycle, EPS growth experienced a CAGR > 20% p.a.
- India is currently close to the bottom of the cycle in profitability. Corporate profit-to-GDP is close to 1.5-2.0%, which compared to over

7% at the end of the last cycle, leaves significant room for operating leverage and capex driven earnings growth to come.

- India's market cap is likely to rise from US\$3trillion to US\$5trillion over the next 5 years also due to significant number of IPOs of unicorns and privatisation of some Government owned assets.

Implementation of our view on India

Generally, investors have avoided investing in single country strategies and have sought indirect exposure through Global, Emerging Market and Asian funds.

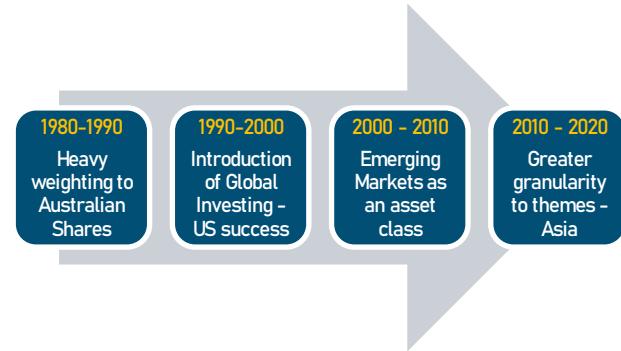
The hypothesis is that generalists are in a better position to know when to enter and exit investments in regions through the understanding of dynamics across several regions. However, it is difficult to imagine Emerging Market fund managers (particularly those based in global financial centres) are going to be across the dynamics of 26 countries with little or no relationship to each other.

Hence our preference is for investors to make portfolio complementary, direct, and “deep” structural allocations to regions like China and India to benefit from the compounding nature of earnings driven by strong demographic fundamentals.

The evolution of global investing

Typically, investors have preferred broader based strategies such as Emerging Markets or Asia funds. However, it is obvious to understand the shift that is taking place over time. 25 years ago, local investors were reticent to invest overseas given a strong local Australian stock market with the attraction of franked dividends and several industries which operated in a moat.

Figure 1 – Equity Investing in Balanced, Growth and High Growth risk profiles



Foreign investment was gradually increased in the name of diversification and to access a much broader opportunity set. At the forefront of the mindset was allocations to the US, UK, European and Japanese markets where some of the best companies with massive addressable markets were to be found. Global giants in Healthcare, Consumption and Technology were not available in Australia.

In 2003 a paper written by Jim O'Neill of Goldman Sachs, talked about “Dreaming with BRICS”. This brought increasing attention to Emerging Markets through the growth profile of developing economies relative to local economies. Product proliferation led to large investment managers expanding their opportunity set to cover companies in China, Brazil, Korea, India, Russia etc. This would expand the capacity of these global asset managers, whilst they remained headquartered in London, New York, Boston, Singapore, Tokyo etc.

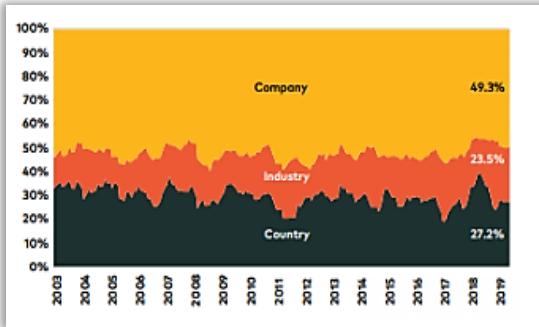
Fast forward to the decade gone by and several investors started to look at Emerging Asia with greater interest. Asia's weight in the EM has essentially swamped Latin America, Middle East, Africa, and Eastern Europe.

The implementation problem

Let us consider why Emerging Market and Asian funds have risen to prominence. It has largely been a product proliferation opportunity for global asset management firms to extend their existing labour base to a broader opportunity, with a recognised benchmark or yardstick to measure against.

However, below we outline what we think the issues of implementing a view on Emerging Markets or Asia by this format:

1. EM/Asia funds tend to gain exposure by holding mega/large caps which are liquid. Ideally ACW focused managers should have an overlapping opportunity set as EM and Asia become a larger component.
2. EM/Asia are tactical investors in regions like China and India and quite often sell at bottoms and buy on momentum, thereby missing the compounding effect of staying invested in regions where mean reversion occurs quickly due to underlying fundamentals. A research paper by in 2019 highlighted that only 25% of value-added by Emerging Market managers came from "country selection".²



This is because generally EM teams are set up with sector and stock specialisation and based in major financial centres rather than within the emerging economies themselves.

3. These funds can classify countries as "expensive" or "cheap" based on the broad comparative opportunity set, without understanding the local fundamentals and potential for compounding or "value-traps" driven by local factors/ecosystem.
4. Country correlations are washed away in a broad strategy, particularly as the large cap stocks in indices are also more correlated with globalised businesses.

Thus, exposure to India or China could be significant, but is likely to consist of large weights in a few mega/large cap stocks. This may not be ideal when aiming to maximise "growth" and "diversity" which investors sign up for when seeking to invest in these high growth economies. It is more a function of product structure, fund size and capacity constraints.

We provide some examples of the above with respect to exposure to India in our analysis below:

Across 20 of the most used EM funds, the weight to India is approximately 11.7% (slight overweight to India weight in MSCI EM). A range of 50-100% of the exposure was within India's Top-20 by market cap. Particularly amongst the higher conviction, larger sized funds, this is essential to avoid liquidity issues posed by withdrawals. The most popular holdings are Reliance Industries, HDFC Bank, Tata Consulting Services, Infosys, HDFC Limited and Hindustan Unilever – all leaders in their markets and beneficiaries of past business cycles.

² AGF Investments – Country allocation in Emerging Markets 2020

A Case Study:

HDFC Bank vs Zomato

HDFC Bank is a success story of the past business cycle as private banks won market share from troubled State-owned banks which had non-performing assets from the last corporate lending cycle. HDFC Bank focused on banking to India's top 100m corporate wage earners and benefitted from the consumption/credit cycle of households over the past 10-15 years. It is now the stalwart of every EM/Asia fund as one of the premier quality banks across not only India and Asia, but globally. Its valuation reflects that 4xBV. It is a play on India's growth and consumption – albeit its valuation recognises this.

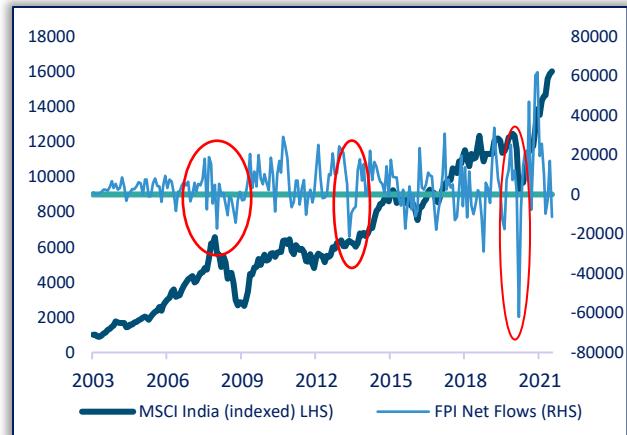
Compare and contrast this to Zomato – a non-profit making business which recently listed on the Indian markets via IPO. Zomato is the leader in food-delivery in India and operates across several markets globally in restaurant ordering and food delivery. Given only 8% of Indian food is consumed outside of home or is non cooked organically, the growth of the addressable market could be significant especially given India's youthful, time-poor population with an increasingly changing family nucleus (young adults moving out of home).

Our argument is that investors should have a mix of large successful businesses in large markets as well as emerging/strong businesses in growing addressable markets which will be the beneficiaries of the next cycle – not just purely index heavyweights which got there because of past successes.

In fact, many foreign investors (EM/Asia funds) argue the case that India looks expensive as a market and we agree that areas like financials and consumption stocks, having been beneficiaries of the last cycle are expensive. However, several companies below the mega-cap, mega-liquid threshold have more

acceptable valuations given their potential for compounding growth.

Chart 7 – Foreign Portfolio Investments (INR crores)



Source: fpi.nsdl.co.in, MSCI, India Avenue Research

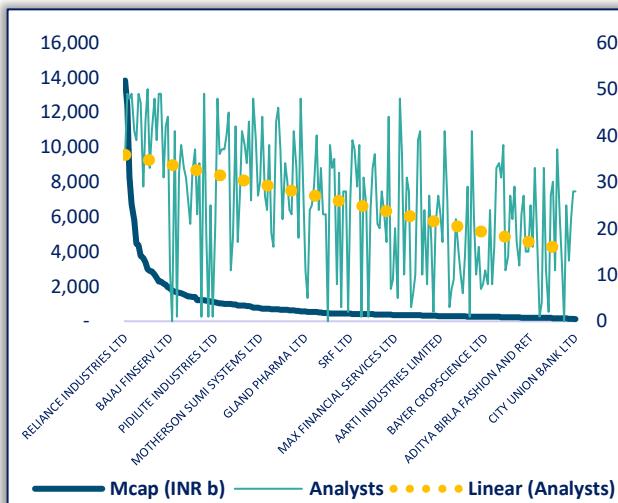
The chart above indicates that foreign investors typically withdraw during a crisis i.e., 2008, 2013, 2020 and 2021. Unfortunately withdrawing funds when markets are low and missing the market upswing is telling in India. The policy of building exposure during weakness provides superior results as the long-lasting fundamentals return to present themselves as eye-catching to investors.

By our calculations the difference between pulling money out at every crisis point i.e., GFC, Taper Tantrum, Fragile Five, Oil Crisis and Covid-19 (wave 1 and 2), **foreign tactically oriented investors leave 3% annualised on the table relative to strategic long-term investors**. This is accentuated if additions are made during crisis points rather than withdrawals.

Why Active, Why Local?

Emerging Market economies like China and India have stock markets which are less efficient in price discovery than advanced economies like the US, UK, Japan etc. This is particularly the case once you look below the top 100 stocks by market cap, where broker coverage drops dramatically.

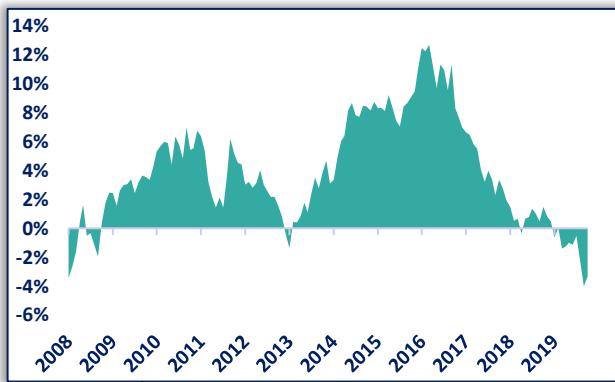
Chart 8 – Broker Coverage vs Market Cap



Source: Motilal Oswal, India Avenue Research

It is our view that investors should seek exposure to markets like India through partnerships with locally based investors who have been managing money locally over a decade or so.

Chart 9 – Local Indian Managers – Rolling 3-year alpha



Source: India Avenue Research, AMFI, Refinitiv

Gross alpha achievements of the local mutual fund industry reveal an average gross alpha of 5.9%. This does not include the average of 10% alpha achieved over the last 12 months. Whilst alpha achievements are cyclical, the compounding effect of this run-rate is significant and can make a significant difference to the investment decision.

Knowledge of the local ecosystem of market participants including founders (who own 40% of the market cap), foreign investors and local HNI and retail behaviour is important. From a business perspective, apart from understanding the Government/Central Bank focus, it is also critical to understand local nuances associated with suppliers, producers, customers, competitors, and employees of businesses. Locally based investors understand the compounding nature of earnings of Indian corporates far better than tactically minded foreign investors.

As we already noted investing in single countries provides greater diversity to portfolios given the specific dynamics of each region.

Our portfolio recommendation

It is our view that the portfolio recommended will outperform typical global equity portfolios of clients as well as the MSCI ACWI over the course of the decade.

2-3 ACWI benchmarked managers who can “go anywhere” which includes investment in companies like Samsung, Taiwan Semi, HDFC Bank etc. (78%).

A highly active EM manager who is focused on companies benefitting from local demand and supply dynamics rather than investing purely in large and liquid companies (14%).

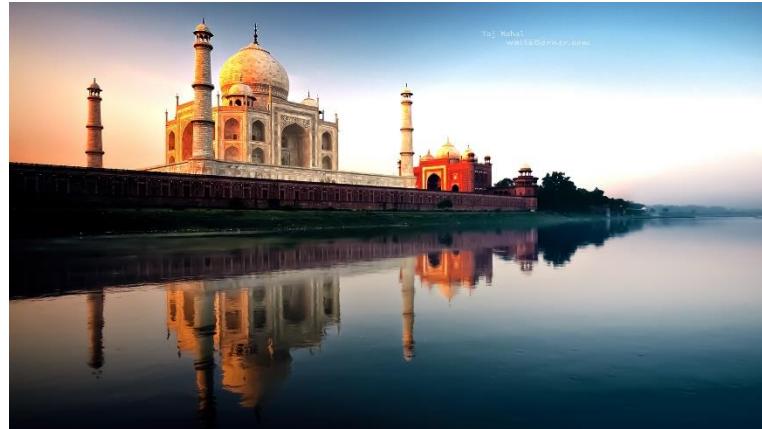
Single country allocations to China (5%) + India (3%).

The correlation of India and China to each other over the last 20 years is 0.15 – extremely low for equity markets. Country correlations can be much more transparent than generalist strategy correlations which tend to allocate significantly to EM domiciled firms with a global client base. Therefore, increasing correlations to global developed markets.

Table 1 – Recommended Portfolio

	Portfolio Weight	China	India
ACWI Managers	78%	4%	1%
EM Strategy	14%	6%	1%
China	5%	5%	
India	3%		3%
	100%	15%	5%

The recommended portfolio results in an output aggregate exposure to China + India of circa 20%, which more closely resembles their economic significance rather than existing market cap weighting in the MSCI ACWI.



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