



India Avenue
Investment Management

SPICE UP YOUR PORTFOLIO

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INTRODUCTION

Many investment practitioners claim that investors are faced with a low return environment for the foreseeable future. Anchoring this claim are expensive valuations of most asset classes. Equity markets appear expensive relative to historical valuations and bond yields are at unprecedented levels. In fact, approximately \$12trillion of global debt is in negative territory today¹.

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today*

Whilst returns have been good for bonds over the past two decades (since 1994), this has primarily come from capital gains made from falling bond yields. This is not sustainable looking forward, unless bond yields go significantly below zero. The risk reward trade-off appears to be extremely unattractive at these levels. The impact is likely to be felt in a more significant way when many of these bonds mature and there is a need to roll over into new investments. Many investment managers are finding it difficult to redeploy capital and are being forced to invest in securities with longer dated maturities and lower credit ratings to generate returns. This is worrying as;

1. Credit and liquidity risk increases. In fact, some corporate bonds have negative yields
2. Investors rely on further declines in interest rates to make money
3. Duration by definition rises as yields fall. This can make the risk of rising rates even more painful for investors. In fact, the duration of global bonds is currently at record highs²

When investing in equities, generally low interest rates are favourable as the yield on competing investments fall and companies are able to borrow at cheaper rates to fund projects. However, this favourable environment has played out to a large extent, making expectations of future returns from appear less exciting. This coupled with low inflation, low global economic growth and weak sentiment from the private sector, suggests that earnings growth is likely to remain weak. Particularly when most businesses have spent most of the period since the financial crisis growing their bottom line by cutting significant costs out of their business already.

With share prices still elevated despite the challenging environment, valuations for many share markets around the world appear expensive relative to their historical valuation. In this paper we highlight the following points to successfully navigate this difficult environment;

- A low potential return environment requires differentiated thinking
- Short term monitoring of investment portfolios causes investors to focus on volatility which ultimately can lead to poor long term decision making
- Income strategies do not equate to safety. You can still lose capital and you need to consider the opportunity cost of not investing in certain investments. Capital growth investment strategies should not be ignored
- Diversification is becoming harder to find. Truly diversified strategies should have logical reasons for their differentiated returns rather than only looking at historical price correlations
- Indian equities can provide compounding earnings growth driven from increasing earnings generated by companies. This is a true differentiator in today's environment.

*With share prices still
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share markets around
the world appear
expensive*

¹ Negative-yield government debt surges \$1.3tn to \$11.7tn, FT, July 1, 2016

² Will duration risk rear its head for bond investors? FT, April 29, 2016



SO WE LIVE IN A LOW RETURN WORLD. WHAT CAN WE DO ABOUT IT?

We feel to paint all assets with the same “low future return brush” would be misleading. In such a difficult environment, finding opportunities requires investors to think outside traditional asset classes, rather than simply ploughing savings into perceived “safe” assets such as cash. The danger with “investing safely” is that it exposes investors to the risk of falling short of their investment objectives, and in particular for retirees who has the risk of outliving their savings.

The average Australian is living to 80.1 years for males and 84.3 for females³. This is of course just an average, but unfortunately many retirees financially plan for their retirement using average life expectancies. This approach significantly exposes retirees to significant risk of outliving their savings. For example, the average 65-year-old female retiree will live to be 87.1.

However, 10% of her cohort will live to 96 and if we factor in improvements in health care this increases to 99 years old! This risk can have a major impact, especially where retirees do not expect to run out of savings, but face this prospect when it is too late to take any action. To put this into a real life scenario, the Association of Superannuation Funds of Australia (ASFA) estimates that a retiree will need \$40,297 per year to provide a comfortable standard of living in retirement⁴. Given that the full rate age pension is currently just over \$18,000 per year for a single pensioner, the risk of shortfall is meaningful.

Therefore, we should also focus our attention on investment strategies that are capable of generating long term capital growth. Admittedly this has been difficult given the dearth of unique international investment opportunities readily available for Australian and NZ investors. However, we feel that an allocation to growth assets such as Indian equities can spice up your portfolio with the objective of generating long-term wealth. This is not because we think India is a short-term opportunistic trade, but rather that the long-term structural dynamics facing Indian companies are positive which can lead to significant wealth creation for investors. We will explore why exactly India is an attractive investment destination and what it can provide for Australian or NZ investors later in this report.

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WHERE ARE THE LONG TERM INVESTORS?

Academic studies have demonstrated the value of a long-term, buy-and-hold approach to investing⁵. However, the use of such an approach remain at odds with the short-term behaviour that has become increasingly characteristic of investors in equity markets. Superannuation investing enforces a long-term investment horizon. The median age in Australia is 37.1⁶ years, which means they have approximately a 30-year horizon within the superannuation framework (assuming they withdraw it upon retirement). So if our investment horizon is so long, why do many investors react to news and market volatility by trading so frequently. In fact, investment horizons seem to be shortening even further!.

³<http://www.aihw.gov.au/deaths/life-expectancy/>

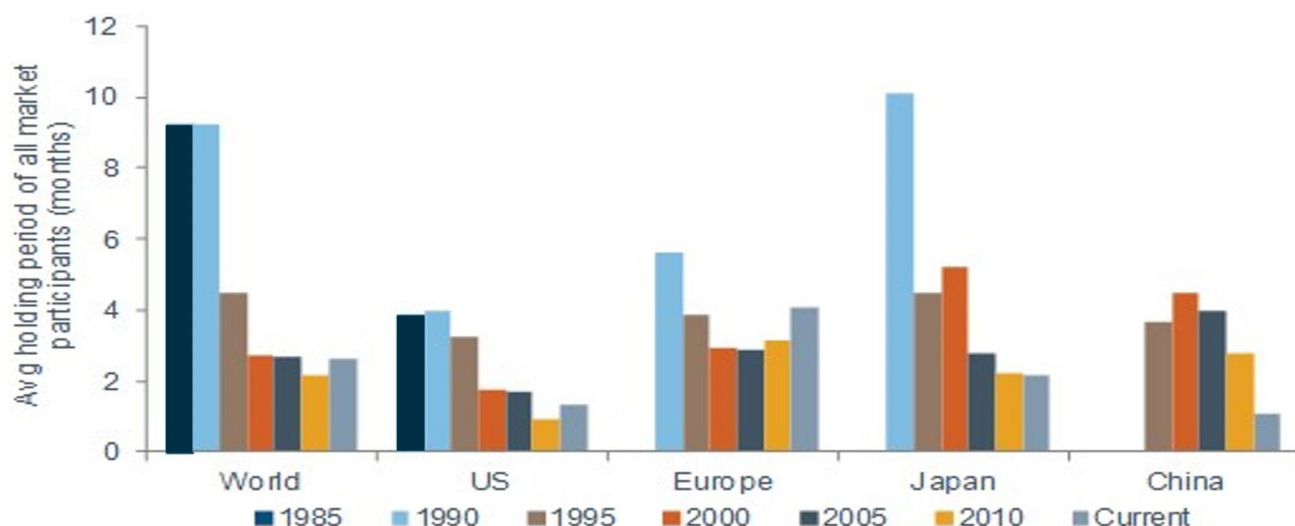
⁴ASFA Retirement Standard, March quarter 2012

⁵Reorienting Portfolio Strategies and Investment Management to Focus Capital on the Long Term, Mar 2015

⁶<http://www.abs.gov.au/ausstats/3101.0> - Australian Demographic Statistics, Jun 2014



Figure 1: Average holding periods have fallen



Source: Goldman Sachs. Average holding period of all market participants by region, January 21 2016.

Some of the key reasons that long-term investing has been “crowded out” is due to behavioural biases, increasing access to information and competitive pressures. These are described below;

1. Inherent behavioural biases can cloud our judgement, preventing us from making optimal investment decisions. We are more averse to losses than gains and thus emotions force us to act irrationally. For example, availability and timeliness of information can cause investors to place an undue weight on recent events, forcing them to sell at exactly the wrong time.
2. There is a plethora of data readily available for investors today. Whilst in theory this should provide investors with more information and knowledge, it in fact has led to excessive noise and distraction. This coupled with sensationalised media, means that we as investors go from worrying about one thing after another, forcing irrational decision making.
3. Many professional investors base their asset allocation and performance hurdles on peers. With performance data monitored so frequently and bonuses for investment professionals tied to peer groups, the time frame for success has narrowed.



Forecasting outcomes, especially in the short-term is wrought with danger. The desire to make short-term forecasts mean that we often end up engaging in speculation. Studies show that forecasters are good at extrapolating an existing trend rather than successfully predicting turning points.⁷

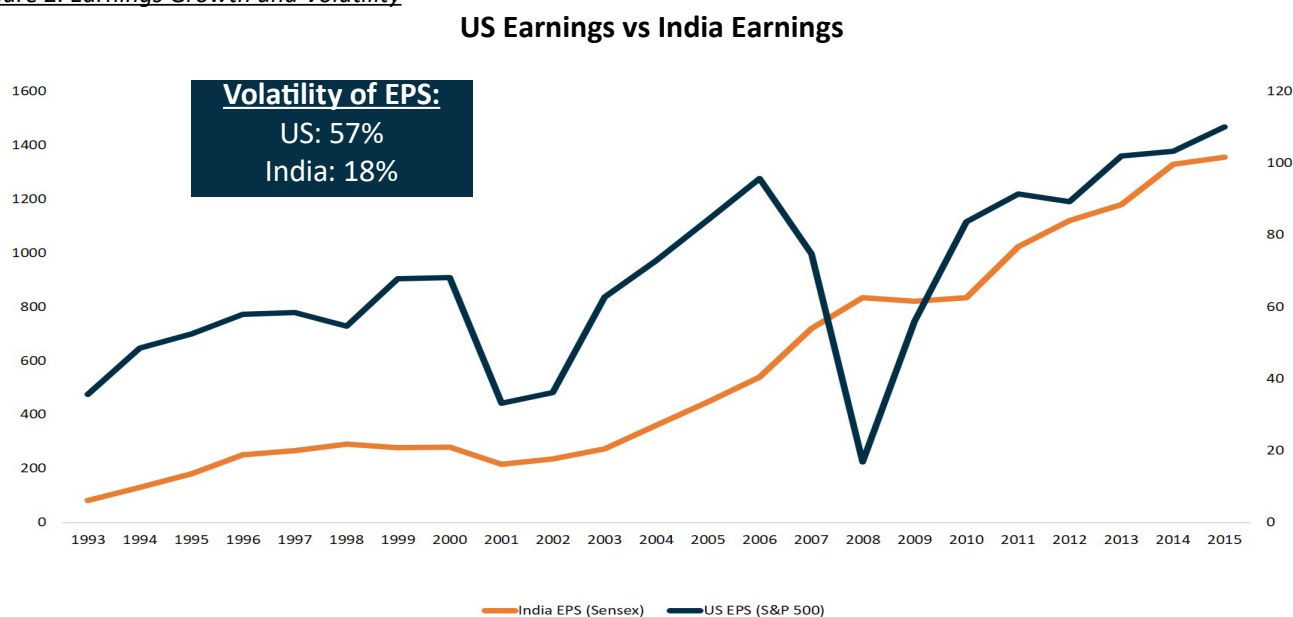
Whilst fundamentally sound long-term investment strategies may experience volatility in the interim, it can create significant wealth over time. Ideally, long term investors can absorb interim volatility and ignore the daily "noise" of equity markets.

To put this into perspective, share market returns are driven by either earnings growth or valuation multiples (e.g. price-earnings multiple). Over short holding periods, changes in valuation multiples are the key driver of returns since earnings expectations do not typically change by large amounts. However, over longer periods, share market returns are increasingly explained by changes in earnings growth and the importance of entry and exit multiples diminish⁸. Valuation multiples are often driven by sentiment and risk appetite, which is very difficult to evaluate. However, correctly identifying companies or markets that are experiencing strong and sustainable earnings growth can create significant wealth for shareholders.

The Indian share market is a prime example where companies have generated substantial earnings growth over the long term. Earnings growth has been 14% p.a. compared to the US 8.9% p.a. In the short term, equity prices can be volatile despite consistently strong earnings growth. However, if we take a longer term perspective, equity returns from India have rewarded investors who have ignored short term volatility and not made irrational, myopic investment decisions. Figure 2 below compares earnings per share growth and its volatility for both the US and India. Despite India's higher price volatility (of the broader share market), the US has experienced substantially higher volatility in its earnings. In Australian dollar terms, MSCI India has delivered returns of 12.4% p.a. compared to the S&P500's 5.3% p.a. over the last 14 years .

With share prices still elevated despite the challenging environment, valuations for many share markets around the world appear expensive

Figure 2: Earnings Growth and Volatility



Source: Goldman Sachs. Average holding period of all market participants by region, January 21 2016.

⁷For a useful summary see "Economists are (still) clueless" by John Maudlin in *Thoughts from the Frontline*, 15 June 2013.

⁹Earnings growth since 2001 for S&P500 and Sensex, Bloomberg and MSCI

¹⁰MSCI India and MSCI US Gross returns since June 2002

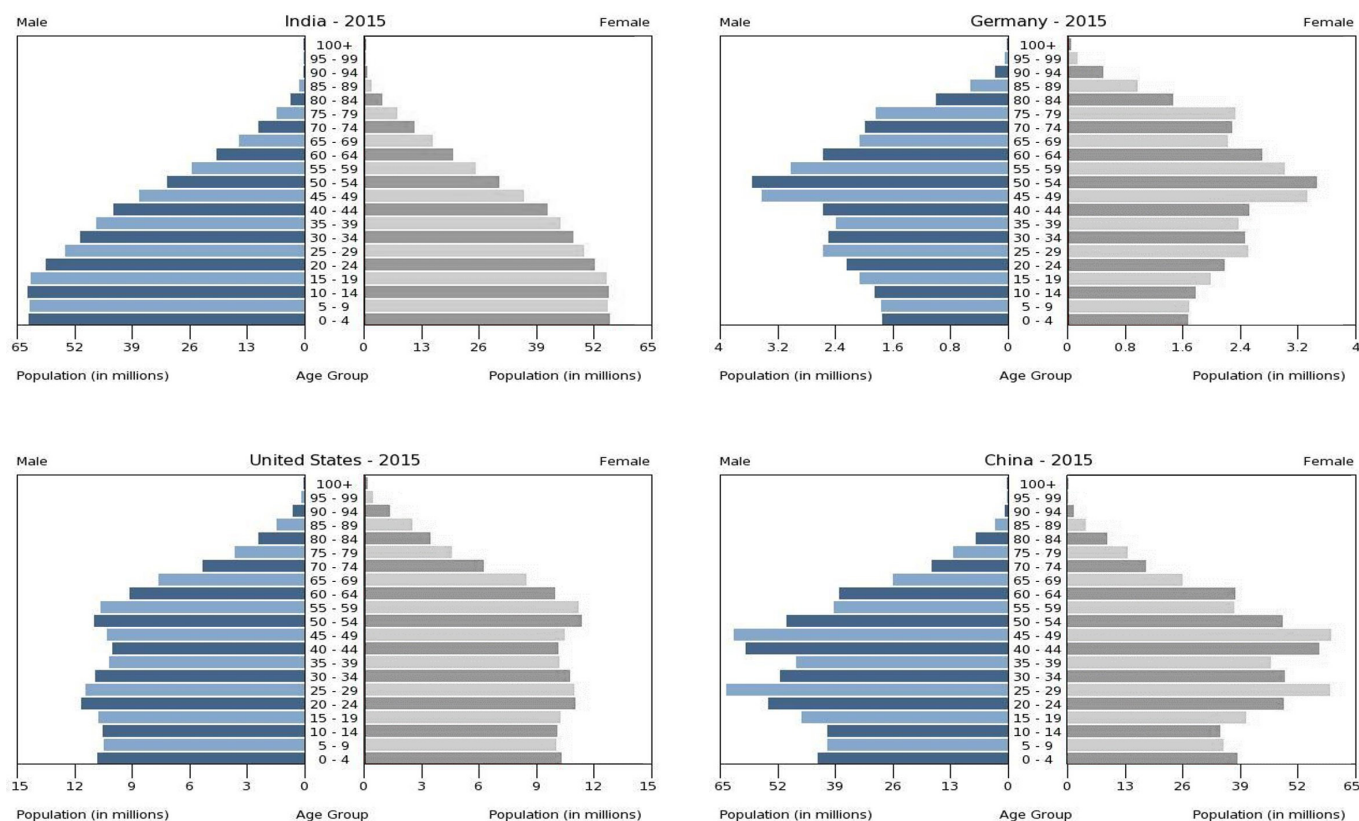
⁸A number of academic studies, such as Sorensen and Ghosh (2010), support this point.



WHY INDIA?

A significant part of India's long term growth potential is driven by its large youthful demographics, increasing productivity particularly through use of technology and significant and growing labour force. Looking at the population pyramids below, the age distribution of India is heavily skewed towards the most productive part of the population, unlike many other countries around the world.

Figure 3: Age Demographics



Source: UN Population Statistics

In economics, the phenomenon where falling fertility rates and a young population result in the labour force growing faster than the population dependent on it is known as a demographic dividend. The demographic dividend is expected to reap benefits for India as the country's per capita income grows more rapidly during this time. This is likely to provide a tailwind to economic growth and lead to higher consumption and expenditure from both the public and private sectors. Ultimately feeding through to a large part of India's GDP as private consumption makes up 60%.

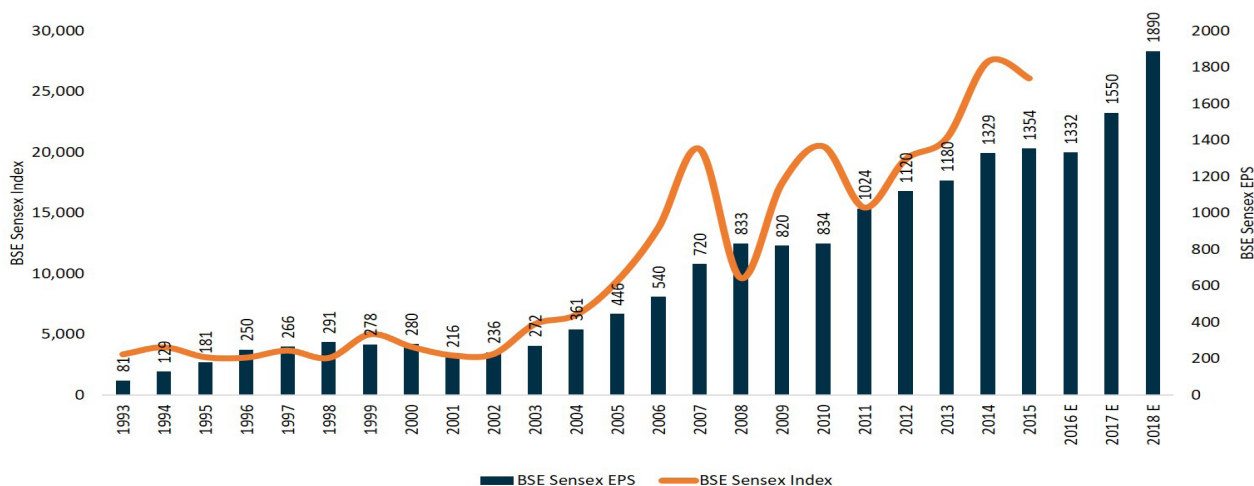
During the global crisis, corporate earnings in India were resilient, even though price-earnings multiples fluctuated wildly, due to heightened fear of owning shares. However, as mentioned previously, investors in equity markets should maintain a focus on long-term fundamental factors such as earnings growth and identify if there has been any structural change. For example, in the US and Europe post the global financial crisis, perhaps the lower capacity of banks to fund business projects may have had a structural impact on longer term earnings growth achievable by corporates operating in those markets.



The chart below shows that the blue line clearly follows a similar trend to earnings over time as investors benefit from capital growth achieved through company earnings.

Figure 4: Earnings vs Stock Price Movement - India

Earnings vs Stock Price Movement - India



Source: Bloomberg

Table 1: AB: High RoE and Quality Earnings Growth

Furthermore, Indian corporates have consistently managed to maintain a high return on equity (RoE). In fact, the RoE of large Indian companies was above 14% even during the crisis period as companies were able to capitalise on resilient local consumer demand to offset much of the anaemic global growth. Indian companies exhibit a very favourable combination of high earnings growth and return-on-equity with low earnings volatility compared with other emerging and developed markets.

| MSCI Index | Std Dev of EPS Growth | Avg ROE Growth |
|-------------------------|-----------------------|----------------|
| India | 13% | 18% |
| China | 19% | 13% |
| Brazil | 44% | 13% |
| Russia | 45% | 13% |
| Emerging markets | 27% | 13% |
| All Country World Index | 34% | 12% |
| US | 33% | 15% |
| Developing markets | 35% | 12% |

Source: Morgan Stanley Research

It is our view that the quality and growth of India's corporate earnings is likely to be superior to many other markets going forward due to the following points;

- Strong top line revenue growth** – The GDP reflects the size of the opportunity presented to most corporates. This is likely to expand through increasing consumption and expenditure from both the private and public sector. Furthermore, the current level of infrastructure is inadequate relative to the size and needs of the Indian population. Hence infrastructure spend is likely to be significant in the future. All these factors are likely to add to GDP growth and conducive to corporate earnings growth going forward.
- Stable EPS growth** – Indian share markets have a diversified industry profile, dominated by companies predominantly focused on growing their earnings through local consumption demand, rather than offshore sales which may be more volatile going forward given sub-trend global economic growth.
- Sustainable capital management** – Indian corporates have been able to deliver and maintain higher RoE through 'sweating' their assets and managing costs, creating more efficiently utilised shareholder capital.
- Government initiative** – A significant focus on the Ease of Doing Business is leading to an improvement of business processes and reducing red tape and increasing productivity. An example is the passing of the GST which will improve the efficiency of resource allocation



HOW CAN WE MONETISE THIS OPPORTUNITY? TWO COMPANY EXAMPLES

To understand how the Indian growth story can be monetised, we highlight two companies in India that are experiencing and are expected to strong earnings growth. There are over 6,000 companies listed in India, making it the largest in the world by listings, so the opportunity set is vast!



Description: Jubilant FoodWorks is the master franchisee of Domino's Pizza Inc. in India and is the market leader in the organized pizza market with a 50% overall market share and 70% share in the home delivery segment in India

The Market Size: The Indian food services industry is worth AU\$50bn and is projected to grow to nearly AU\$90bn by calendar year 2018¹¹. Affordable and competitive pricing, innovative food products and providing a higher level of consumer convenience has led to the rapid rise of the quick service restaurants (QSR) segment in India. Customisation in their offerings in terms of flavours, pricing, services, etc. to meet Indian consumers' evolving preferences, tapping digital media and store roll-out has resulted in continuous expansion of the consumer base.

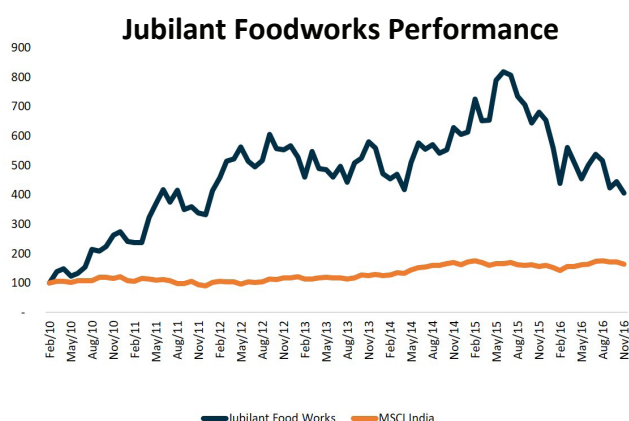
Figure 5: Store Growth



Source: Bloomberg

The Opportunity: The Indian consumer is driven by special occasions to indulge in dining out or ordering in. "Eating Out" has now become an occasion / behaviour driver in itself. Multiple factors spur the "Dining Out" culture and correspondingly, the growth of the organised food services in India. This includes:

Figure 6: Name: Performance vs MSCI India



Source: Bloomberg, MSCI

- Pro-growth demographics (increased youth population & more working women, 583 million middle class by 2025, 64% working age population and average age of 27 years by 2021¹²)
- Higher disposable / discretionary income
- Greater urbanisation (India expected to add 404 million urban dwellers by 2050¹³)
- Changing consumer preferences – widening exposure to new cultures and cuisines
- Growth in organised or chain retail
- Increased travel and transit locations
- Growth driven by digitisation (online ordering facilitated by 200 million smart phone users and over 330 million internet users in 2016)

¹¹Indian Food Industry, July 2016, <http://www.ibef.org/industry/indian-food-industry.aspx>

¹²World Bank, data.worldbank.org/indicator

¹³World's population increasingly urban with more than half living in urban area, www.un.org

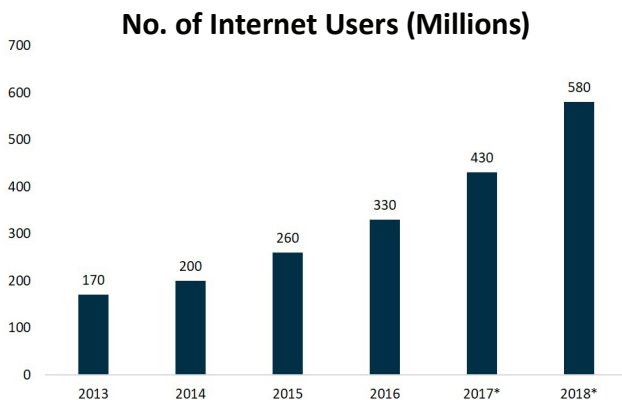




Description: Info Edge (India) Limited is India's premier internet classifieds company in recruitment, weddings, real estate and education services. Info Edge has been able to bring about a migration of offline transactions and communities in India to the internet by successfully using technology to provide a superior online experience.

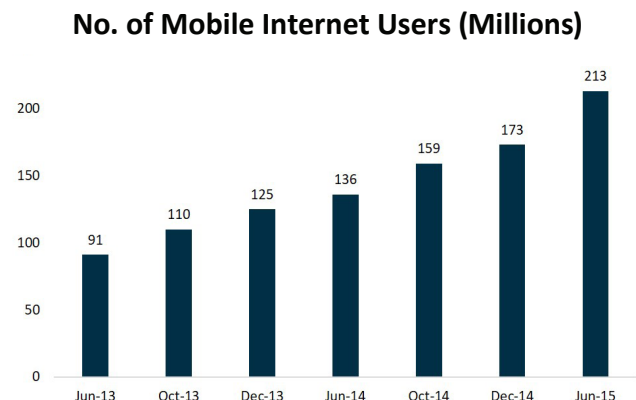
The Market Size: The digital chart below plots the growth in internet users estimated by the Boston Consulting Group (BCG) and suggests that the internet population in India will reach over half a billion users by FY2018¹⁴. A digital population of 500 million could transform India's economy, business landscape, governance and society onto a whole new playing field.

Figure 7: Internet User Growth



Note: *Forecasts. Source: Bloomberg

Figure 8: Mobile Internet User Growth

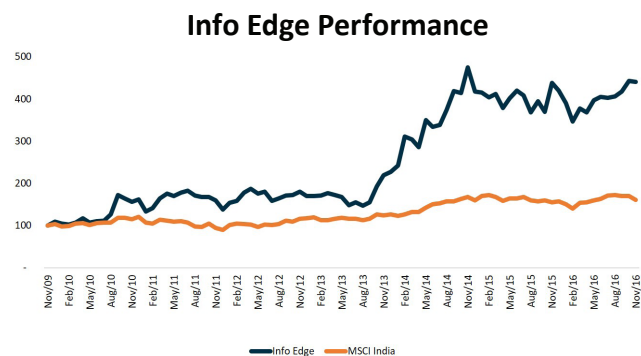


Source: Bloomberg

The Opportunity: In 2001, India had 7 million internet users. By December 2014, the number reached 300 million¹⁵. That is a 30-fold increase over 13 years. This, however, doesn't paint the full picture. It took 10 years to get to the first 10 million users and another decade to hit the first 100 million. The next 100 million were added in four years — between 2010 and 2014. This growth trend is expected to continue, and the next 100 million is expected to be reached in one year. The primary drivers have been the expansion into rural towns, increased affordability due to lower cost handsets and an ever increasing awareness and need for internet. India is the second largest market for social networking giants like Facebook and LinkedIn. Some 58,000 new users get connected to a social network every day¹⁶. E-commerce is transforming online shopping and is expected to have many positive repercussions on the Indian economy.

- Internet growth could spawn an economy worth US\$200 billion from internet related activities. This is a four-fold increase from today and by 2018, internet related activities are expected to contribute approximately 5% of GDP¹⁷.
- Provide a fillip for entrepreneurship and wealth creation and will push GDP per capita higher. With 500 million users, it will be the size of Europe.
- Internet growth will also lead to job creation. About 400,000 people find direct employment because of the internet and BCG estimates that this will expand to 2,000,000 by 2020.

Figure 9: Performance vs MSCI India



Source: Bloomberg, MSCI

¹⁴The Rising Connected Consumer in Rural India, bcgperspectives, August 10th 2016

¹⁵Internet in India 2015, Report released by the Internet and Mobile Association of India (IAMAI) and IMRB International

¹⁶Internet in India 2015, Report released by the Internet and Mobile Association of India (IAMAI) and IMRB International

¹⁷Internet in India 2015, Report released by the Internet and Mobile Association of India (IAMAI) and IMRB International



LOOKING BEYOND THE TRADITIONAL APPROACH

Many leading practitioners have overhauled their approach to portfolio construction by adopting new frameworks, tools and techniques to deliver client objectives. Their rationale for changing their philosophy has been due to the following issues with the traditional approach.

- **Strategic asset allocation (SAA) has its flaws:** One major draw-back of the traditional approach is that it groups assets into “buckets” which reduces the portfolio’s flexibility and limits portfolio diversity. These buckets mean that investors often pigeon hole investments and are less open to new strategies since they don’t fit a prescribed asset class bucket. This results in investment strategies that typically don’t fit being excluded from consideration, despite being fundamentally sound and/or incrementally additive to a portfolio. It also excludes new and emerging asset classes until they achieve mainstream status such that they can be classified into one of the buckets.
- **Achieving portfolio objectives is what ultimately matters:** Whilst it is important to do as much homework as possible on each investment, it is paramount to adopt a portfolio approach to achieving objectives. Managing each asset class to an arbitrary index, rankings or peer group, whilst also maintaining the portfolio’s objectives can be conflicting.
- **Volatility is not the only definition of risk:** The definition for many investors, remains solely the volatility of prices. As Warren Buffett once noted, using volatility as a measure of risk means that “an asset that has dropped very sharply compared to the market becomes “riskier” at the lower price paid than it was at the higher price”. This is clearly a flawed proposition. In our view, volatility is a proxy for fear which often leads to irrational investor behaviour. This is because higher volatility and short-term monitoring of performance due to a “loss aversion bias” can lead to panic selling exactly at the wrong time.

To overcome the above issues, many practitioners have followed alternative approaches to deliver better investment outcomes for clients.

- The asset allocation and selection process is simply a portfolio that has both short-term assets (cash and short term liquid interest rate securities) and long-term assets (equities, longer dated fixed income, credit, alternatives etc.) This can be constructed to maintain the portfolio’s alignment to a client’s objectives, often being to preserve and grow real returns
- An objective-based portfolio seeks to target a particular portfolio outcome through bespoke investment strategies that aim to achieve the investor’s objective. Each new asset class is considered, given the role it plays in improving portfolio diversification, without sacrificing the portfolio’s return potential.
- Risk should be considered as permanent loss of capital (as opposed to capital losses on paper), not meeting investor goals (e.g. generating real wealth, managing interest rate risk, liabilities etc.) or as outliving their retirement savings. Rather than relying on quantifying risk as a single number, the assessment of risk should be multi-faceted.

Looking beyond the traditional approach enables a more positive investment thesis for Indian equities that we described earlier. It is our view that Indian equities can play a role as a long-term asset, seeking to deliver capital growth to an investor’s portfolio. In particular, it complements Australian equities which emphasise after-tax yield as a key driver of returns or quasi-coupon bearing instruments (hybrids), both of which feature heavily in a local investor’s portfolios.



WHAT DIVERSIFICATION DO INDIAN EQUITIES PROVIDE?

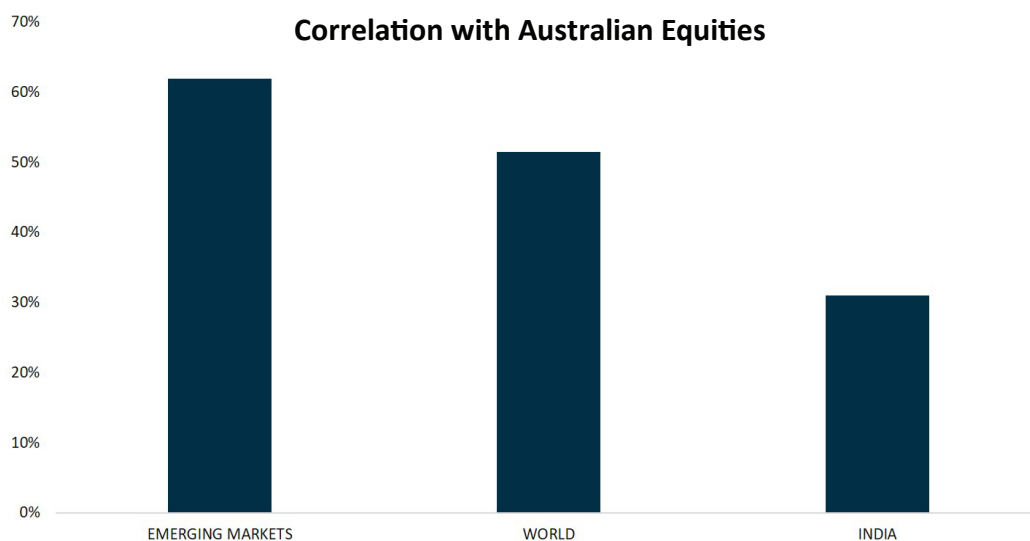
In a nutshell, Indian equities provide the following benefits

- Low correlation with commodity prices and commodity producing countries, like Australia. Pension Funds from countries such as Norway and Canada, which are in a similar position, have invested heavily in Indian equities
- Complementary sector exposure for an Australian investor, looking for consumer, healthcare, information technology companies growing revenues strongly
- Less impacted by financial flows than exposures like ETF's that replicate specific indices

The rationale and evidence for these diversification benefits are described below.

Investing internationally provides access to different economies and industries which typically may not be represented significantly in Australian equities. In theory this would suggest that an Australian investor could improve their portfolio diversification through an exposure to share markets of other developed and developing economies. Whilst this has been somewhat true, the benefits have been somewhat less than expected as can be seen in figure 10 below.

Figure 10: Correlation with Australian Equities since Jan 1993



Source: MSCI, India Avenue

Indian equities have provided significantly more diversification than both global equities and emerging market equities over the last 23 years. We feel there are three major reasons why correlations have been low and why we expect this remain the case in the future:

1. Low correlation with Australian equities and commodities

Unlike Australia, India is a large importer of commodities. Indian consumers have a lust for investing in Gold, driven by a form of wealth increase and for jewellery consumption. Additionally, almost 70% of Oil consumption¹⁸ is imported and this is set to increase as the supply-demand gap widens. Coal is another important commodity for India, particularly given its reserves are low in quality and cost a lot to extract. India in fact has to look to

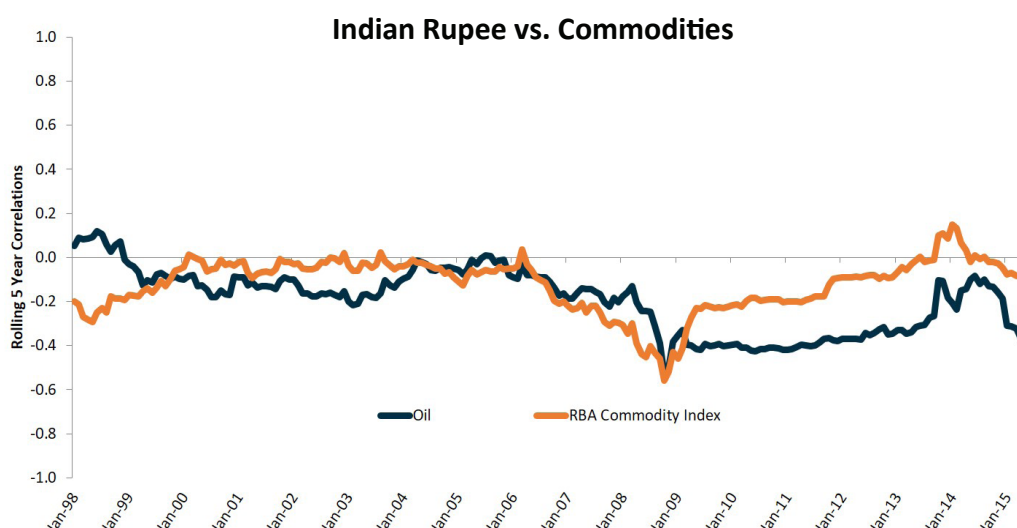
¹⁸Energy Information Administration (EIA): India, www.eia.gov



countries like Australia for coal supply¹⁹. Falling commodity prices are therefore a significant tailwind for the Indian economy, particularly benefitting the Indian Rupee.

We recommend an unhedged position to Indian equities since the Indian rupee could potentially boost returns whilst also adding a level of diversification. In other words, we see international exposure as a diversifier, which improves the risk-return metrics of a portfolio. The low correlation to commodity prices is shown in figure 11 below.

Figure 11: Indian Rupee and Commodities Prices

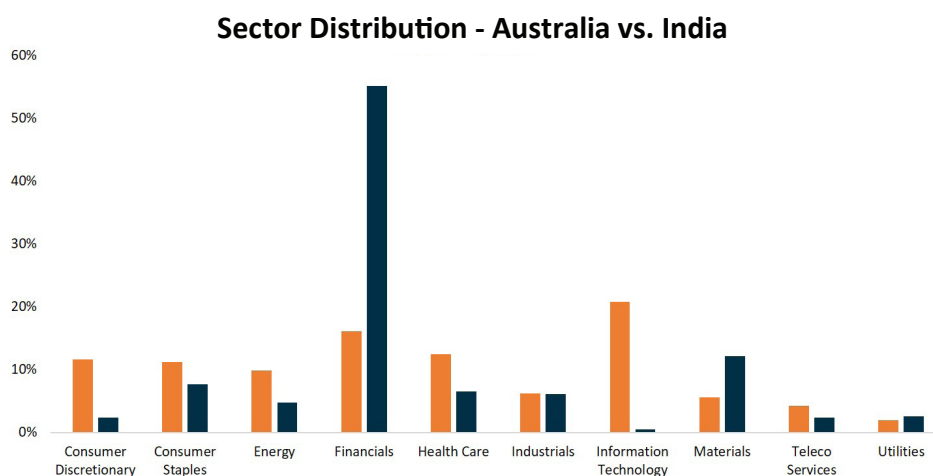


Source: RBA, India Avenue

2. Different sector exposures

The Indian equity market contains over 6,000 listed companies spread over many industries. This makes India's share market the largest in the world by number of listings. Whilst there are nearly 2000 listed companies in Australia, there is a significant concentration in Financials and Resources which make up a whopping 67% of the index²⁰. Inversely there is significant under-representation in IT, Health Care and Consumer Discretionary, relative to the rest of the world. India's share market on the other hand has significant exposure to these sectors. The difference in MSCI sector exposures are shown below.

Figure 12: Sector Exposure



Source: Bloomberg, India Avenue

The Indian equity market contains over 6,000 listed companies spread over many industries. This makes India's share market the largest in the world by number of listings

¹⁹ Coal in India, 2015, Mark Cully, Chief Economist, Australian Government, Department of Industry and Science

²⁰ Bloomberg and MSCI

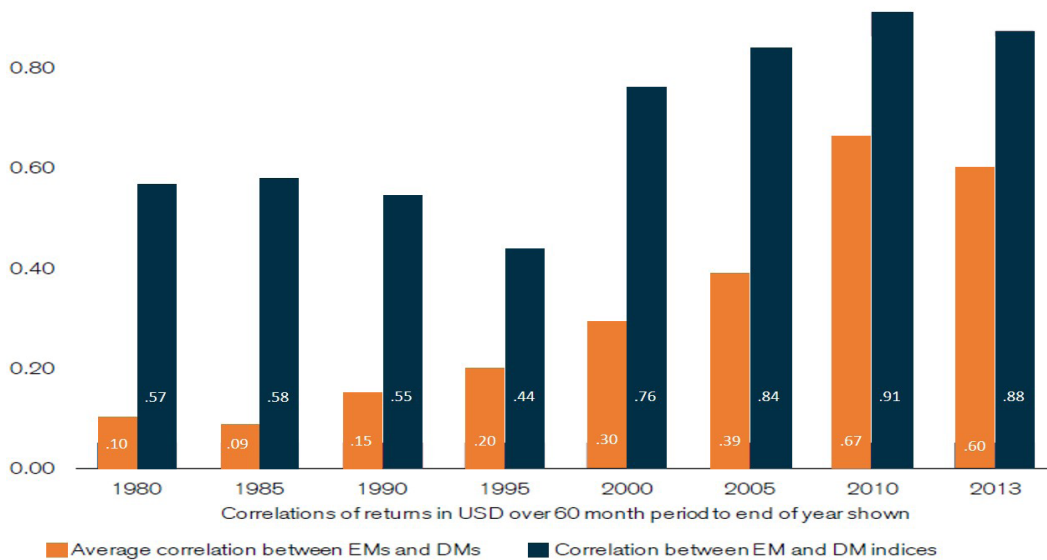


3. Basket trading/ETF trading

Traditional asset classes have seen a rise in correlations due to increasing use of ETF's for passive indexing, which tends to group assets into clusters. This means that assets are predominantly impacted by financial flows and sentiment, rather than fundamental changes. Furthermore, today's emerging market (EM) indices are dominated by large, global companies with the bulk of their revenues being sourced globally, rather than providing true exposure to the local economy's fundamentals. Figure 13 below illustrates this rising correlation of assets due to indexing and ETF trading of mainstream assets. In this case developed markets and EM correlations have risen from 0.4 in 1995 to 0.9 in 2013. This compares to India which has a correlation of around 0.3 with global equities²¹.

Figure 13: Rising correlation of traditional assets

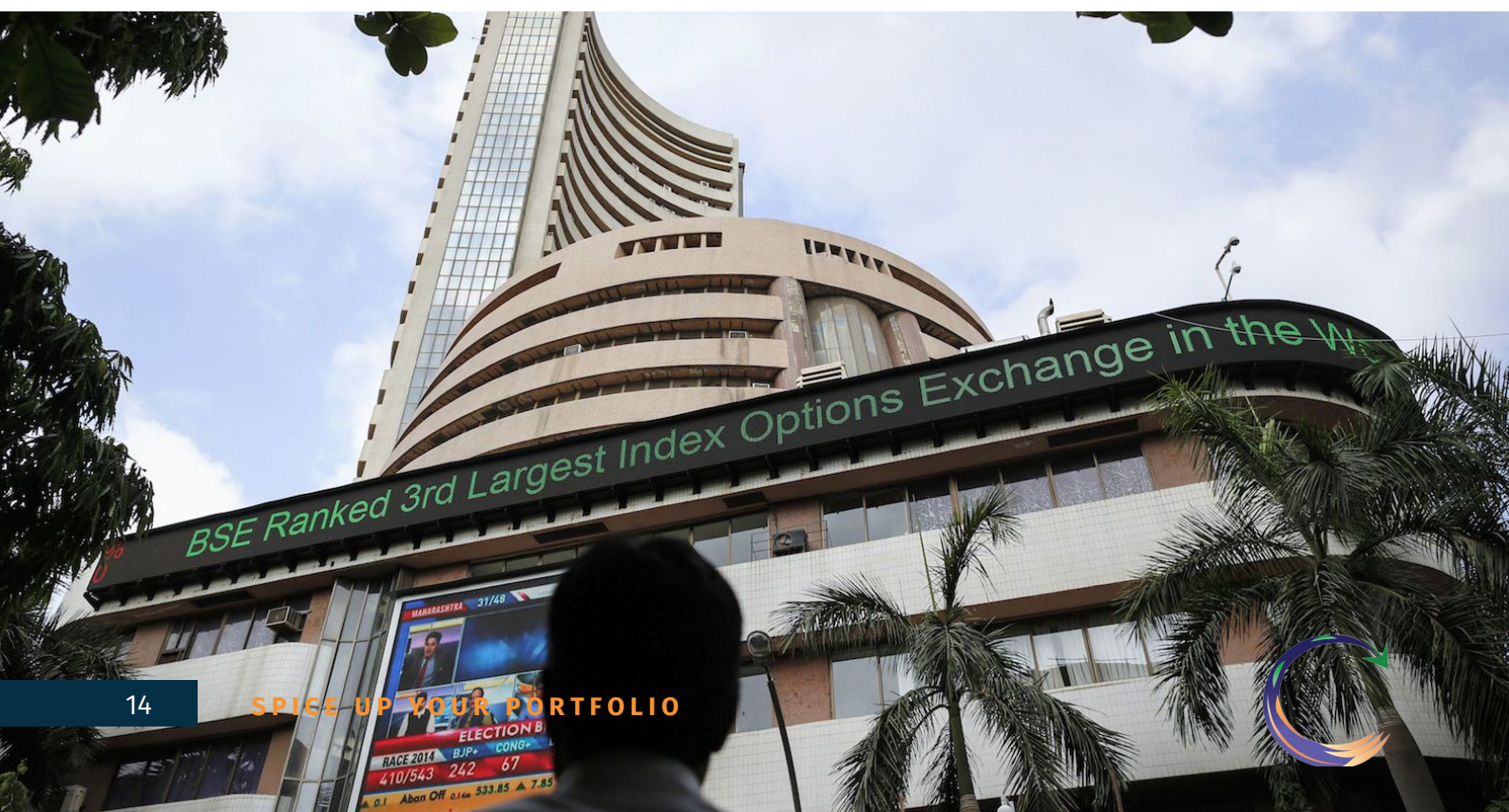
Correlations between EMs and DMs over time



This compares to India which has a correlation of around 0.3 with global equities

Source: Elroy Dimson, Paul Marsh and Mike Staunton using data from MSCI Barra and SP/IFCG

²¹Elroy Dimson, Paul Marsh and Mike Staunton using data from MSCI Barra and S&P/IFCG



UNDERSTANDING THE RISKS

Like any investment, there are risks associated with it. In our view the best way to think about risk, is to assess the impact of various scenarios and determine whether the return potential is enough to compensate you. Furthermore, long-term thinking allows you to look past the events that often masquerade as risk, but in the long-term create nothing but noise in managing a portfolio.

Table 2: What are the Risks and their Potential Impact?

| Risk | Potential Impact | Our View |
|-----------|--|--|
| Currency | The Indian rupee has depreciated against the AUD by 4% p.a. over the last 23 years. Although this is low compared to the AUD's appreciation against other EM currencies (7.4% p.a.) it could impact performance of an Indian equity investment ²² . This has been predominantly due to higher inflation levels in the Indian economy. | Although historically this has been the case, our view is that the AUD has many headwinds going forward. The Rupee provides diversification for an Australian investor given the inherent commodity theme. The cost of hedging the Rupee is currently 4%, which makes it somewhat expensive. and therefore a cost benefit analysis needs to be continuously monitored. |
| Equity | Drawdowns in the Indian share market have been high at times, however the global financial crisis saw falls in line with that of the ASX200. Nonetheless, the recovery period was relatively swift. Indian equities often trade at a premium in terms of valuation relative to other EM share markets. | Taking a long term approach, mitigates this risk to a large extent. Nonetheless, valuations across sectors, companies and market capitalisations can become extreme at times, and thus an active approach that identifies and manages periods of higher risk, is paramount when investing in Indian equities. |
| Commodity | India is the 3rd largest energy importer in the world and price rises can lead to adverse impacts fiscally and on the trade deficit. This can have material impacts on inflation and FX reserves leading to Rupee, interest rate and share market volatility. | The Indian government is looking to diversify their energy intake through the use of solar energy and other renewables to reduce this import reliance. |
| Political | India is a complex political, cultural and economic landscape with 1.3bn people, 29 states, over 400 different languages, large amounts of bureaucracy and legacy issues of political corruption. Whilst changes are afoot through active reforms, it will take time for the economy to feel the full impact due to India's vastness. | India under the new prime minister, Narendra Modi has made huge progress in terms of reforms such as improving the ease of doing business, reducing bureaucracy and flushing out corruption. We feel that the longer term impact of this is still underappreciated by foreign investors. |

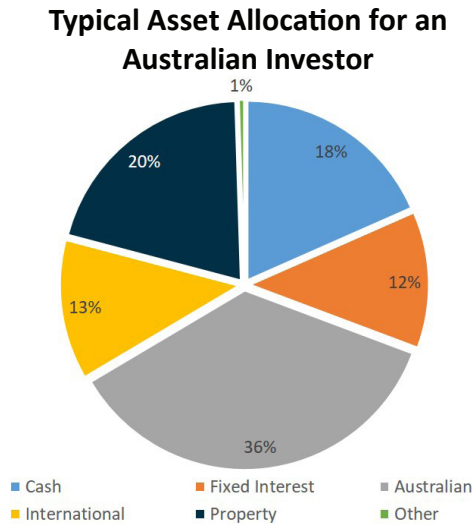
²² MSCI India, India Avenue Research



HOW MUCH SHOULD I CONSIDER ALLOCATING TO INDIAN EQUITIES?

Given the opportunities and value add described earlier to a typical portfolio, how much should an investor consider allocating? Well particularly in this environment we need to increase the capital growth component of our portfolio without increasing the inherent risk beyond our comfort levels. Looking at a typical Australian portfolio²³, Australian equities make up a significant 36%.

Figure 14: Typical Asset Allocation for an Australian Investor



However, International Equities remain only 13% which illustrates the imbalance given Australia is a low proportion of the global economy. An investor should consider a broader opportunity set where possibly to mitigate risks.

Based on generalised levels of risk aversion, amount of growth needed and diversification, our analysis suggests that the allocations below are worth considering. For further information on the quantitative aspects considered in this analysis feel free to reach out to us.

Source: SuperConcepts: The SuperConcepts Investment Patterns Survey Mar 2016

Table 3: Allocation by Segment Type

| Phase | Age Bracket | Allocation | Rationale |
|---------------------|-------------|------------|---|
| Buying assets | 18-30 | 6-10% | Risk aversion is low, but the need for short-term wealth to buy assets maybe high with some investors |
| Wealth accumulators | 31-55 | 8-10% | The longest time horizon of the phases, combined with lower risk aversion, means the appetite for an exposure to Indian equities is higher |
| Pre-Retirees | 56-65 | 6-8% | Whilst risk aversion levels and sequencing risk increases, super contributions allow them to take a dollar cost averaging approach in a disciplined manner, where market volatility can be evened out and still grow their balances |
| Retirees | 66 + | 3-5% | Despite higher levels of aversion to risk, longevity risk means that growth is still required |

Source: India Avenue Research

Whilst existing conventional wisdom would state that an allocation to equities and in particular Indian equities, for a retiree's portfolio would be absurd, it is our view that it is one of ways we can counteract longevity risk, given capital growth is indeed a scarce commodity in global investment markets today. This asset-liability conundrum requires allocation to long term investment themes as a component in portfolios.

Many Australian investors have a hurdle above inflation. We have modelled the optimal allocation based on the expected levels of inflation going forward, amount of growth needed to achieve a premium to inflation and levels of diversification.

| Objective | Allocation | Rationale |
|------------|------------|---|
| CPI + 3-5% | 5-10% | Apart from inflation linked bonds and to some extent Real Estate/Gold, inflation is difficult to hedge. Therefore, to achieve a rate above inflation, certain levels of capital growth is required. As mentioned, Indian equities is a capital growth story rather than a dividend yield play |

²³ The SuperConcepts Investment Patterns Survey March 2016



CONCLUSION

Share markets valuations of companies benefiting from long-term structural growth can always appear expensive when you compare price to today's earnings. However, growth companies need to be considered for their strong rate of compounding growth, which makes them look relatively cheap if they achieve success. Companies with compounding earnings growth can benefit significantly through strong appreciation in their brand value, market credibility and business productivity. The significant benefits of the operating leverage which results from this is under appreciated, particularly by Australian investors. Australian companies have focused on dividends, productivity, logistics and efficiency to drive their share market higher. However, given lack of consumption scale and an ageing population, revenue growth now appears increasingly challenging, especially when casting an eye to the future.

In many places in the developed world, due to weak volume growth, investors are demanding companies distribute dividends rather than reinvesting and generating high RoE's. In a country like India, the reverse dynamic is true as many companies are rewarded for growing their business. Currently India's dividend yield is 1.4% compared to 4.3% in Australia. This is symptom of a share market where companies are focusing on generating capital growth for investors through driving earnings higher, rather than distribution of profits.

For investors facing a life cycle of investing to fund their retirement, the primary task is to accumulate wealth over a relatively long term horizon. However in our opinion, long-term investing refers to a frame of mind rather than investing for a specific period. It refers to investors who can keep calm in times of turbulence and not react to their inherent behavioural biases. This is not to say, that a set and forget strategy is a sure winner, however if the fundamentals of your long-term strategy are still in play, (and the opportunity cost has not changed) investors should stay course so as to not jeopardise their investment strategy.



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