



Exposure to India

India Funds vs EM Funds

DECEMBER 1

India Avenue Investment Management

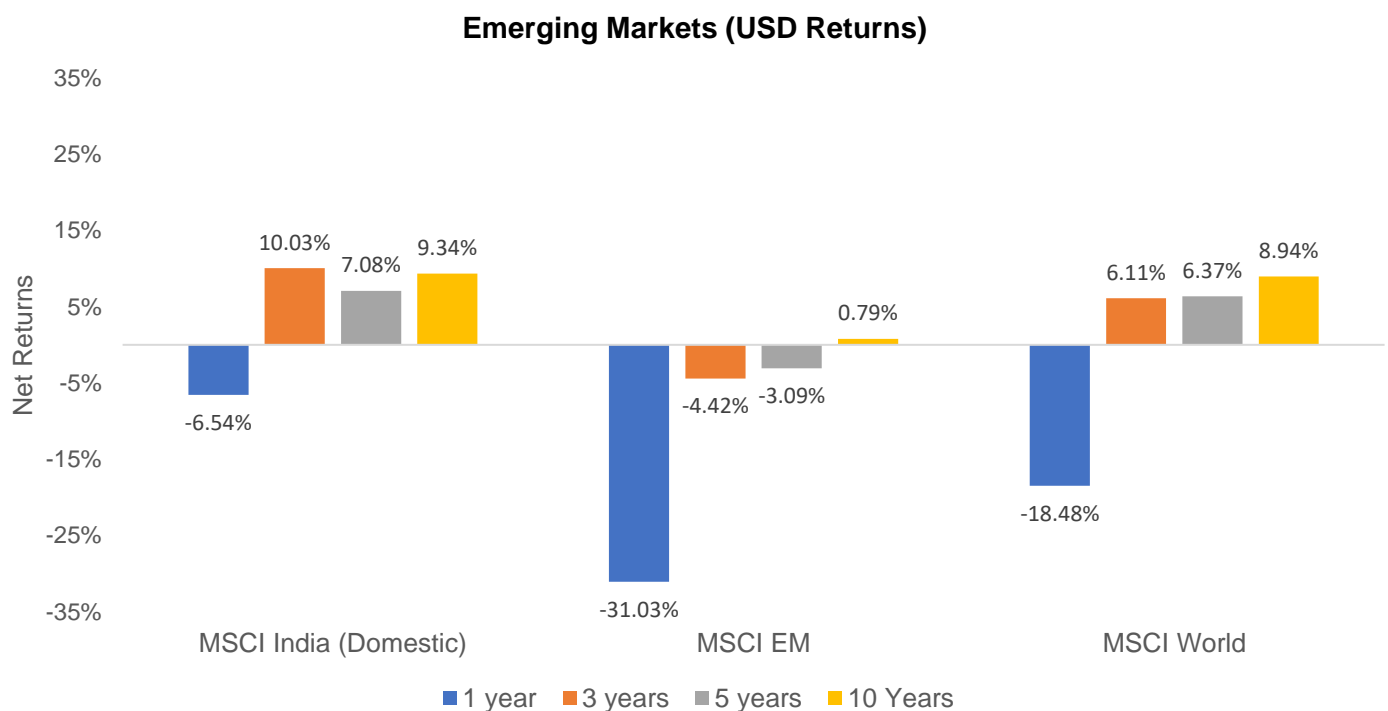
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Exposure to India's Growth Story – Uncovering Myths

India (MSCI India) has been outperforming Emerging Markets (MSCI EM) and for that matter Developed Markets (MSCI World) for over a decade now.

It's no longer the case of do I need exposure to India in my portfolio – it's more a case of how do I get it?



India's investment markets continue outperforming their peer emerging markets over the short and long-term due to the country's undeniable demographics. India is now approaching the point where its dependency ratio is falling rapidly as most of its population is moving into working age. This should lead to the next step of building towards a consumer economy from current level of US\$2,000 GDP per capita. This should create a "producing-consuming spiral" over the next two decades at least.

1. Background and History of Emerging Markets as an Asset Class

The MSCI first launched an Emerging Markets Index in 1988. Since then Emerging Markets has evolved as an asset class with close to US\$ 1 trillion invested in strategies which are aligned to this benchmark. Initially the Index had 10 constituent countries, which has now evolved into 24 countries spread across the globe.

Whilst investors generally accept that Emerging Market constituent countries are growing their GDP at a faster pace due to their rate of development and lower GDP base, it does not necessarily hold that all economies are growing in an aligned manner. However, due to the consensus acceptance of MSCI Emerging Markets, investment flows are often directed towards this grouping based on views of the level of global interest rates and the USD, rather than the specifics of each of the constituent countries or even regional groupings e.g. LATAM (Mexico, Brazil), Asia (China, India, Korea, Taiwan), Middle East (Qatar, Kuwait, Saudi Arabia and UAE) etc.

It's important to understand how the benchmark provider classifies a country. The MSCI follows a strict market classification framework for Developed, Emerging and Frontier Market countries which are separated by three key characteristics related to their economy and/or capital markets:

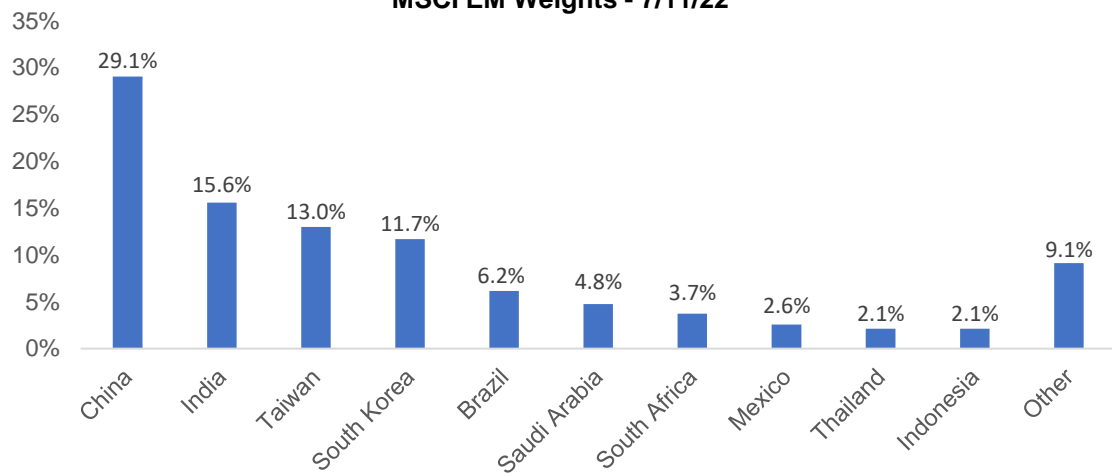
1. Sustainability of Economic Development
2. Size and Liquidity
3. Market Accessibility
 - Openness to Foreign Ownership
 - Ease of Capital Flows
 - Efficiency of Operational Framework
 - Stability of the Institutional Framework

The initial Emerging Market Index held 10 countries, 4 of which have now fallen to Frontier Markets. The Index, as of 2022, holds 24 countries, which can simply be defined by the framework above, along with other key indicators which includes, but is not limited to: GNI, GDP per Capita, education levels and even infrastructure levels. There are currently 23 Developed Markets, 24 Emerging Markets and 32 Frontier Markets (Source: www.msci.com).

The MSCI Emerging Markets has evolved as an asset class in an environment which is predominantly dominated by globalisation. In this period, essentially the US and Europe were dominant in consumption and other economies have sought to be manufacturers which reduce cost through labour cost arbitrage e.g. initially Japan, Korea and China. However, in a more regionalised world, allocation to this asset class becomes more difficult due to dispersion of economic fortunes and capital markets across countries as well as a more diversified investor/wealth base across regions.

The original thought of allocating to Emerging Market economies for growth and diversification across equity portfolios now seems a very high-level thought, which is driven more by convenience and an incumbent position, rather than a deeper understanding of the dynamics of a shifting environment.

MSCI EM Weights - 7/11/22



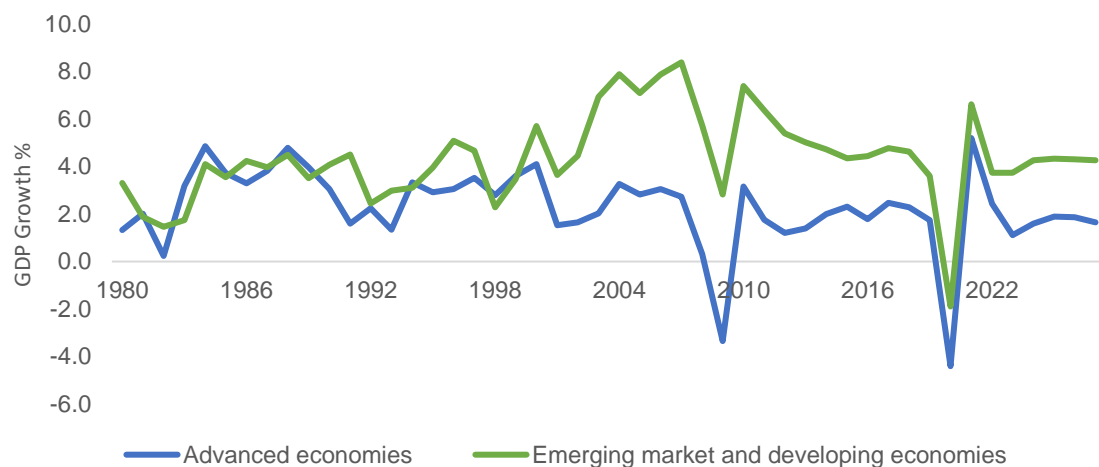
Source: MSCI, Refinitiv

The MSCI EM has the above constituent country structure. Several of these regions are driven by very different economic forces. For example Brazil, South Africa and the Middle East is driven by commodity prices due to the significant weight of commodities related companies in their local economies/markets. Whereas Asian economies tend to be driven by manufacturing, labour cost advantages and scale.

Generally most asset allocators have followed the aggregated approach by directing investment flows towards Emerging Market strategies which allow the fund manager to navigate the terrain of deciding which country, company and currency to favour and accept that the diversified approach of allocating across a group of economies provides a less volatile / risky approach to investing.

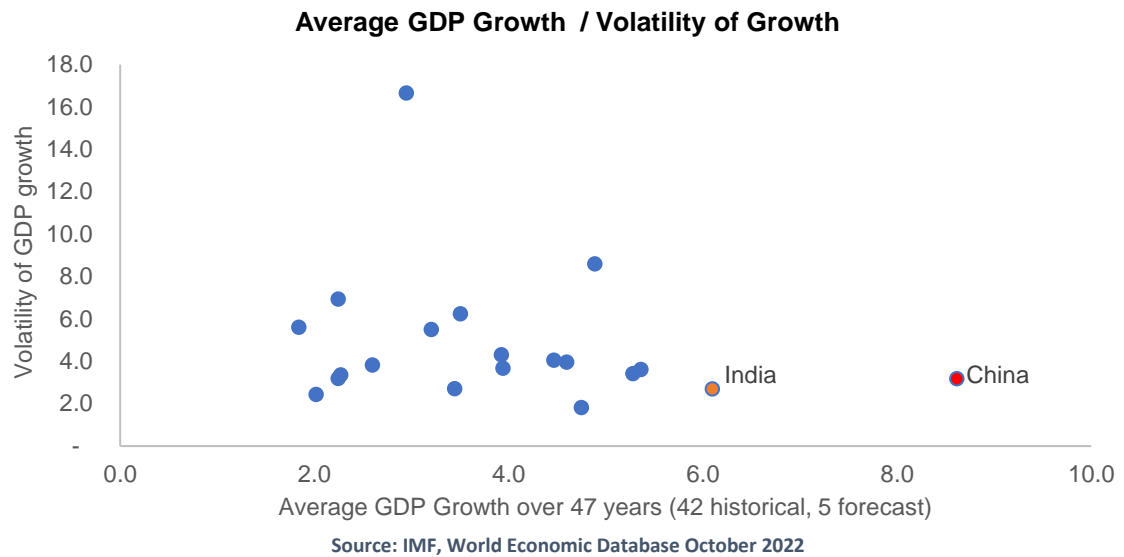
2. GDP Growth: Emerging Markets vs Developed Markets

Advanced Economies vs Emerging Economies



Source: IMF, World Economic Database October 2022

The case for investing in Emerging Markets (average 4.4% GDP) can be made simply by the above group. As a group these economies are growing at a faster pace than Advanced economies like USA, UK, Japan, Europe etc. (average 2.3% GDP growth). Therefore companies from these regions should be able to generate a higher pace of earnings growth given the underlying fundamentals.



Interestingly when we consider the last 42 years and the next 5 years, we can see that there are two economies which stand out being China and India i.e. high GDP growth and low volatility of that growth. This is consistent with structural growth story as opposed to more volatility growth experienced by the likes of the Middle Eastern economies who are more dependent on the fortunes of Oil. China and India are deep investable equity markets due to the size of their economies and stock markets. This provides investors with alternatives to investing in broad based emerging markets funds or a supplementary exposure to their existing holdings to express a structural long-term growth view.

The charts below also highlight that Developed Market economies have a lesser degree of variability in comparison to Emerging Market economies (volatility seen in chart above). This is because the differentiation across largely different political regimes, currencies, regulatory and legal systems is likely to be more significant than dispersion across largely democratic economies with essentially four major currencies (USD, Euro, Yen, Sterling).



An interesting statistic to note is the average growth between these economies. The average level of growth over the past 50 years for Developed Economies is 1.80%, while for Emerging Economies, the average level of growth is 4.54%. This is in comparison to the average growth rate of China and India over the same period being 8.62% and 6.10% respectively.

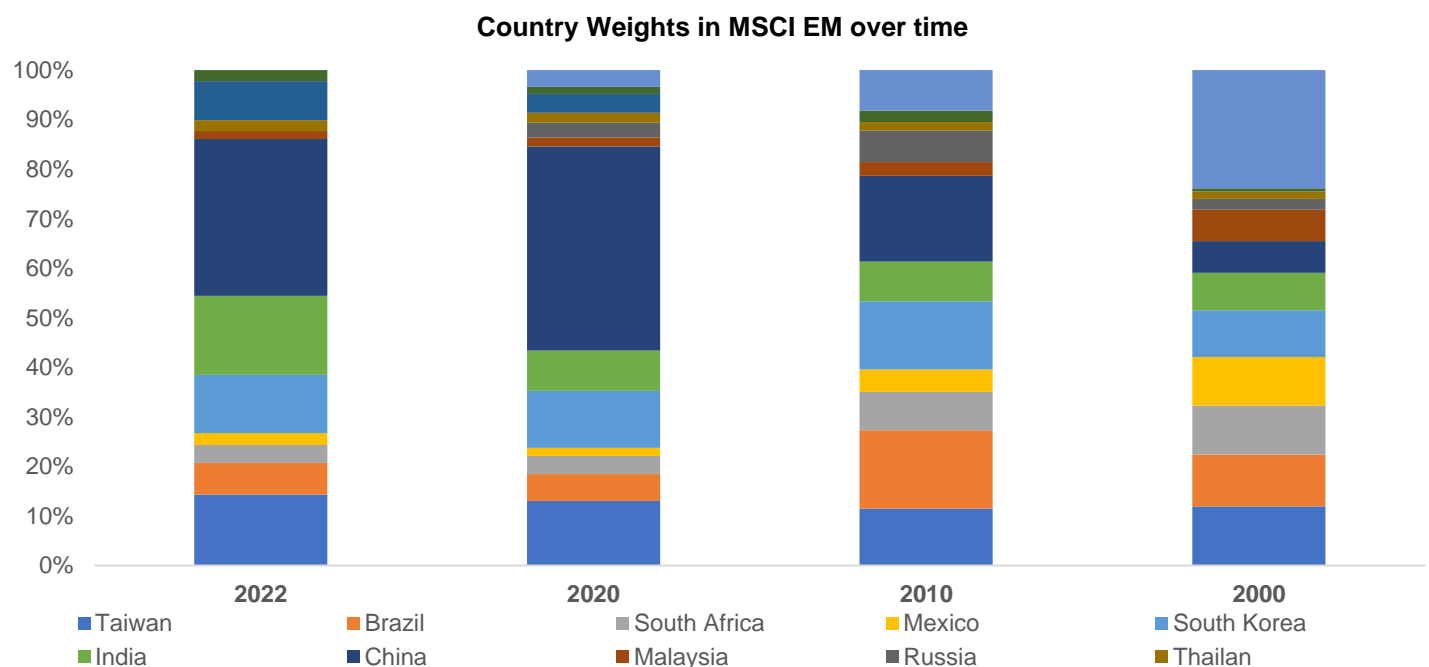
3. Evolution of Emerging Markets

According to MSCI, Emerging Markets are predominantly defined through economic and market factors. These factors hold significance on why countries such as China, South Korea and Taiwan are still considered Emerging Markets. We have assessed the change in the nature of the MSCI EM over time, particularly with reference to the evolution of country and sector weights.

Countries

The graph below shows how the country weights in the MSCI Emerging Market Index have shifted in the last 22 years. China’s growth story began in the mid-1980s, which lines up with its significant increase in weighting by 2020 to over 41%. China’s weighting has grown significantly due to its economic growth and increasing “market openness” over the last decade in particular. However, at the turn of the century, markets like Malaysia and Mexico were far more dominant. Also South Africa and Brazil’s weighting have fluctuated with economic fortunes driven by commodity prices.

The point of this chart is to illustrate that Emerging Markets are very dynamic as economies rise and fall in prominence. A diversified outcome provides a balance of “winners” and “failures” which include different cyclical and structural influences.



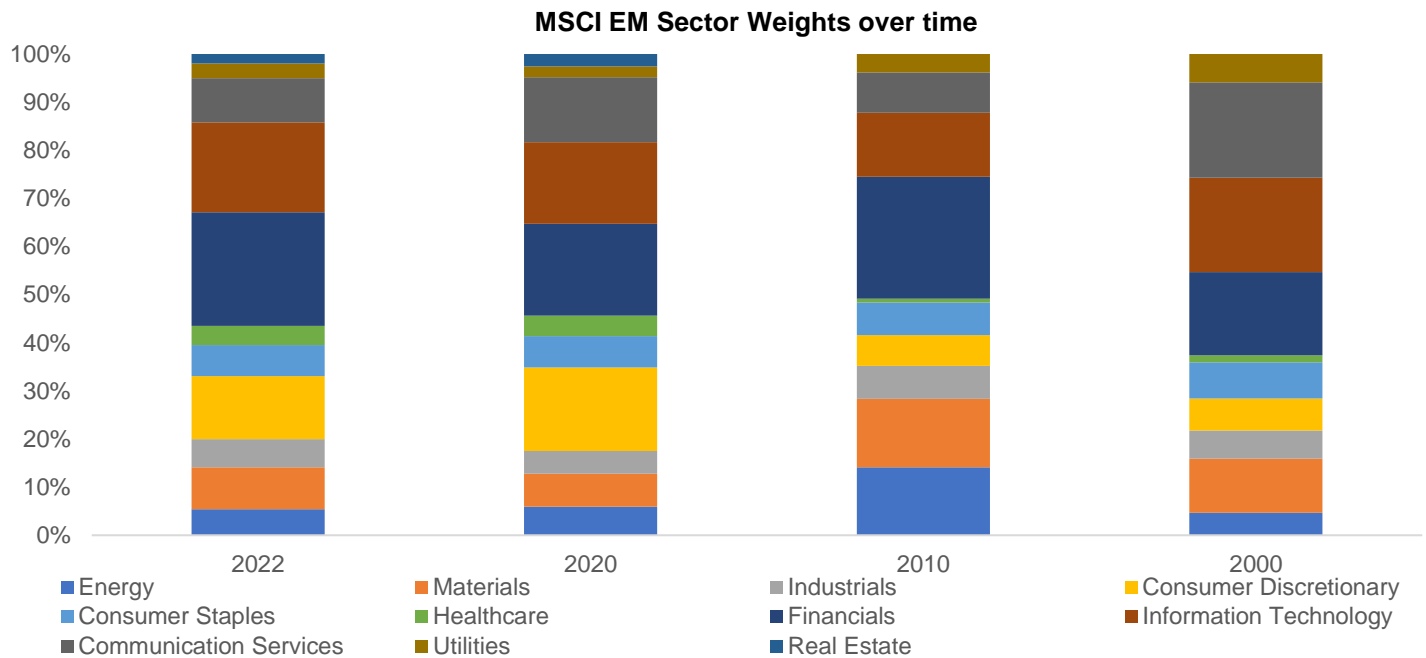
Source: MSCI, MSCI Emerging Markets Index October 2022

As of 2022, the country weights are predominantly among the four economies of China, India, Taiwan and South Korea, making up for 71% of the Index. This has increased from 51% in 2010 and 35% in 2000 and has largely been driven by the rising structural prominence of China and India. There are many reasons why shifts towards and away from various developing economies occur. For example, Brazil is one of these economies which previously held a large stake in the Emerging Market index, at almost 16% in 2010. However, it has been reduced to a mere 6% due to Brazil’s cyclical nature as a commodity-based economy.

In the current context, as significant changes occur in the global supply chains occur, weights have adjusted substantially in just over 2 years from 2020 to 2022. There has been a huge shift in sentiment, primarily away from China. Yet this move was most likely inevitable, as China’s position above 40% of the Index led to increasing sovereign/country risk among investor’s Emerging Markets exposure.

Sectors

The graph below, similarly, illustrates how sector weights have changed over the last 22 years in the MSCI Emerging Market Index. Again the more cyclical sectors have seen bigger swings in weighting i.e. Energy, Materials, Industrials which rose from 2000-2010 before falling in weighting to 2020. Communications and Technology has also been somewhat cyclical thus far as these economies are increasingly “connected”. It is likely that Healthcare, Financials, Technology, Real Estate and Consumption are likely to witness structural long-term increases due to the demographics of Emerging Markets.



Source: MSCI, MSCI Emerging Markets Index October 2022

What’s important to understand here is that when investing, how much diversification is enough? Investing in Emerging Markets as a category has provided a simple manner for investors to gain exposure in one package to growth across several economies. Essentially investors ride the wave of change across emerging markets with their actively managed fund which ideally navigates cyclical and structural forces to generate alpha in comparison to replicating the MSCI Emerging Markets Index.

4. Emerging Markets 2.0

The idea of investing in individual countries has been considered by many to be risky. We have seen this unfold with Russia and China in the last two years. Investors flocked to China with the view that its increasing free-float of China A-Shares would present the opportunity to set up “deeper” single country exposure to the country due to significant weighting in MSCI EM (over 41% at the end of 2020). Additionally, Russia was seen as a beneficiary of higher oil and gas prices spilling over into consumption and banking which would be broadly beneficial to its stock markets.

However, the nature of Emerging Markets is that they have differentiated economic and political regimes and decision making, quite often nuanced by their local dynamics. Picking a country winner in Emerging Markets can yield more successful and efficient results. However the country will need to have the following characteristics:

- Stable political regime / democracy
- Lower regulatory risks

- Structural growth story driven by the demographics
- Deep, investable capital markets, with a strong regulator
- Diverse economy and capital markets, which is less likely to be influenced by an external factor

India's equity market has outperformed Emerging Markets by over 200% in local currency terms over the last 10 years. This has meant Indian equities trade at a significant premium to Emerging Market equities on a one year forward P/E basis. The highest the premium has ever been. However, it is our view that the next decade will continue to see Indian equities outperform Emerging Market equities, whilst providing Australian and New Zealand investors with lower correlation to their existing portfolios.

We continue to advocate a strategic long-term overweight to India in portfolios given its rising prominence of over 3.5% of Global Market Cap and increasing economic significance as expressed by its GDP market share (close to 4%). Most investors currently would have < 0.5% of their portfolio invested in Indian equities (70/30 type risk profile), which we believe underrepresents the opportunity and growth profile of India.

Investor may consider the following:

1. Increasing their weighting to EM via a supplementary allocation to their existing Emerging Market exposure via an actively managed India focused fund; or
2. Substituting some of their existing EM exposure with an actively managed India focused fund to increase their Indian equity exposure – essentially “front-running” the MSCI EM weight to India over the decade.

Allocating directly to Indian equities should always been seen as a piece in the portfolio puzzle rather than a standalone investment. The asset class provides higher growth over the long term, with low correlation to the ASX 200, MSCI World and NZSE 50.

5. Don't I get enough India exposure in my EM Fund?

Typically, investors get exposure to India's growth story through their Emerging Market Funds. Globally focused funds have very little capacity to carry “India risk” relative to their benchmarks. Emerging Markets Funds tends to hold decent exposure to India currently which range from 4-24% presently.

Limitations of EM Funds

- a) Most EM funds remain very similar in nature, especially when it comes to weighting relative to benchmark. There are a few reasons for this, but it essentially comes down to benchmark awareness and business risks.
- b) Teams tend to be headquartered in London, New York, Hong Kong, San Francisco which are major financial hubs where their analysts and portfolio managers are based. Localised understanding of corporate ecosystems is generally absent in these teams and it's more a function of comparative assessment of businesses in sectors across different regions, without deeply understanding local demand dynamics, regulation, governance regimes or business ethics.
- c) When combining several countries together into a basket some of the fundamentals of favourable demographics and structural investment trends can be diluted. As we noted earlier there is significant dispersion in GDP growth across economies in this basket.
- d) Due to size, capacity and broader rather than deeper knowledge, typically EM funds will invest in the larger and more liquid companies in each country. This may include Samsung to represent South Korea, Taiwan Semi-Conductor to represent Taiwan, Infosys to represent India and Vale to represent Brazil. However, these large weights tend to be

focused on global businesses which are domiciled in a country but are very much part of global business and thus correlated to the global business cycle rather than the local one. Whilst these may be great businesses, they also leave less room for growth due to being “undiscovered” by global investors.

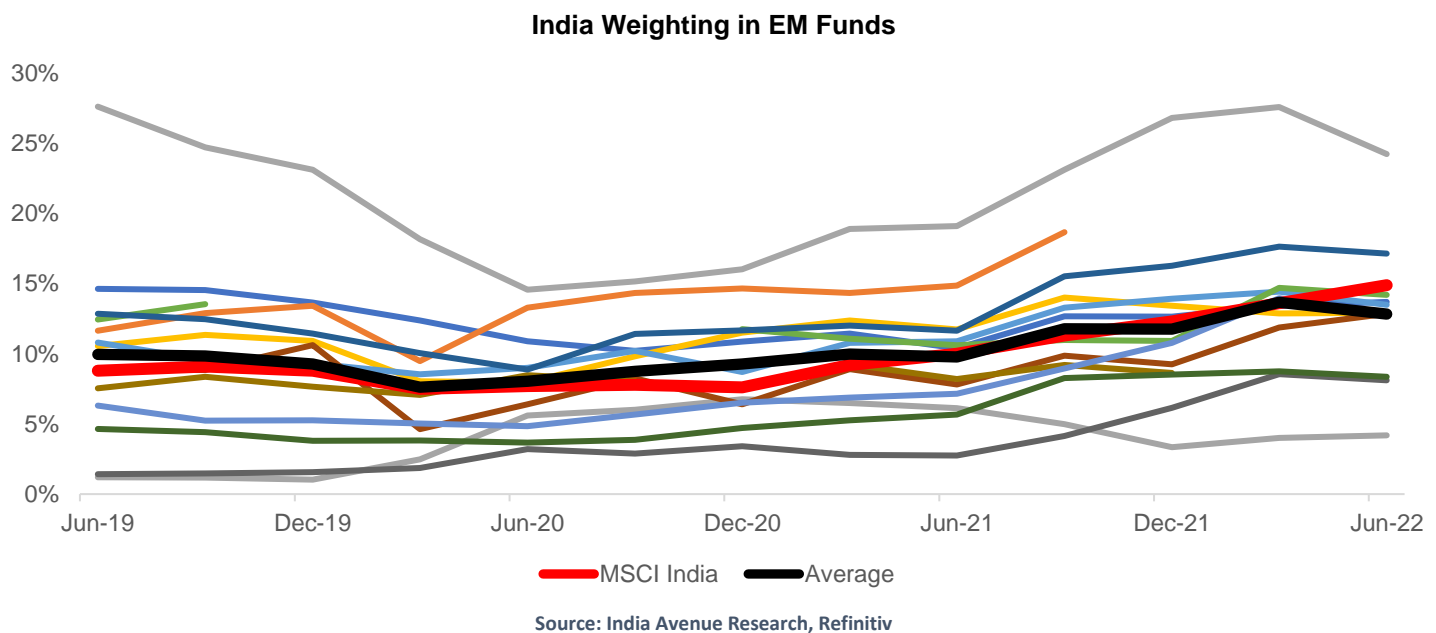
The key idea here is that although these funds are experiencing what can be mostly classified as “good” returns, they aren’t experiencing the “true” growth story within these economies. The Tencent’s, Alibaba’s of the world tend to be invested in after they have experienced significant growth to be a sizeable business, where incremental earnings growth flattens out.

India Exposure

We studied exposure to Indian companies within Emerging Market Funds. Our sample were 13 funds’ all benchmarked to the MSCI EM with collectively over \$100bn invested i.e. close to 10% market share of an asset class with \$1 trillion invested. We studied their allocation and individual country performance of their Indian stocks relative to the MSCI India (Indian subset of MSCI EM) over three years which includes a boom, market shock and rebound.

A variety of factors were analysed over these funds. In particular:

- Weighting to Indian stocks
- Common stocks held by funds
- Returns from Indian stocks over the period
- Overall performance of the India component vs MSCI India over the same period.



What this graph shows us is that the sentiment towards India is gradually changing, especially over this last 3-year period. The bolded red line displays the shift in MSCI India weight, rising from around 8% in mid-2019 to now over 15%.

The bolded black line similarly describes the average, where despite dropping momentarily during the Covid-19 pandemic, the average weight of the funds has also risen from around 10% to around 13%. As a collective most EM managers operate within one standard deviation of the benchmark weighting over time. Can we “front-run” India’s move to 20-25% of EM by the end of the decade?

Stock picking amongst India's 6,000 listed companies

Country-only funds are exactly as they sound, funds which primarily invest in singular countries. They provide various benefits when compared directly to Emerging Market Funds. The primary advantage is that the managers of these funds will have an in-depth knowledge of these economies in contrast with Emerging Market fund managers who will have a higher-level understanding of local dynamics.

Locally domiciled funds, which usually have deeper insight into their macro, micro and corporate ecosystem can provide a clear advantage to investors. It is also likely to provide investors with exposure to companies at an earlier stage of their growth cycle within growing addressable markets.

Our analysis shows that Emerging Market Funds tend to invest in larger and liquid companies, which are far more advanced in their growth lifecycle. These firms are more likely to be growing earnings at close to GDP plus, rather than smaller and medium sized companies which also benefit from “discovery” as they increase their institutional ownership and broker coverage. Additionally, quite often the larger and liquid businesses tend to be those which have had decades of success and been carried to a larger and often more global revenue footprint.

The following stocks are commonly held by several of the EM Funds:

Company Name	Industry	Market Cap US\$bn	MSCI India Weight	MSCI EM Weight	Average Weight in 13 Funds
Axis Bank	Private Bank	32	2.83%	0.45%	0.44%
Bajaj Finance	NBFC – Consumer Finance	52	2.68%	0.43%	0.38%
HDFC Bank	Private Bank	112	0.00%	0.00%	8.85%
HDFC	NBFC – Housing Finance	60	5.62%	0.90%	10.32%
Hindustan Unilever	Consumer Staples – FMCG	72	2.89%	0.46%	2.56%
ICICI Bank	Private Bank	79	6.50%	1.04%	4.01%
Infosys	Information Technology	83	6.97%	1.11%	5.45%
Kotak Bank	Private Bank	48	1.44%	0.23%	4.55%
Maruti Suzuki	Consumer Disc. - Automobiles	34	1.44%	0.23%	2.55%
Reliance Industries	Energy/Communications/Retail	217	10.29%	1.65%	11.95%
Tata Consulting Serv.	Information Technology	151	3.94%	0.63%	2.65%

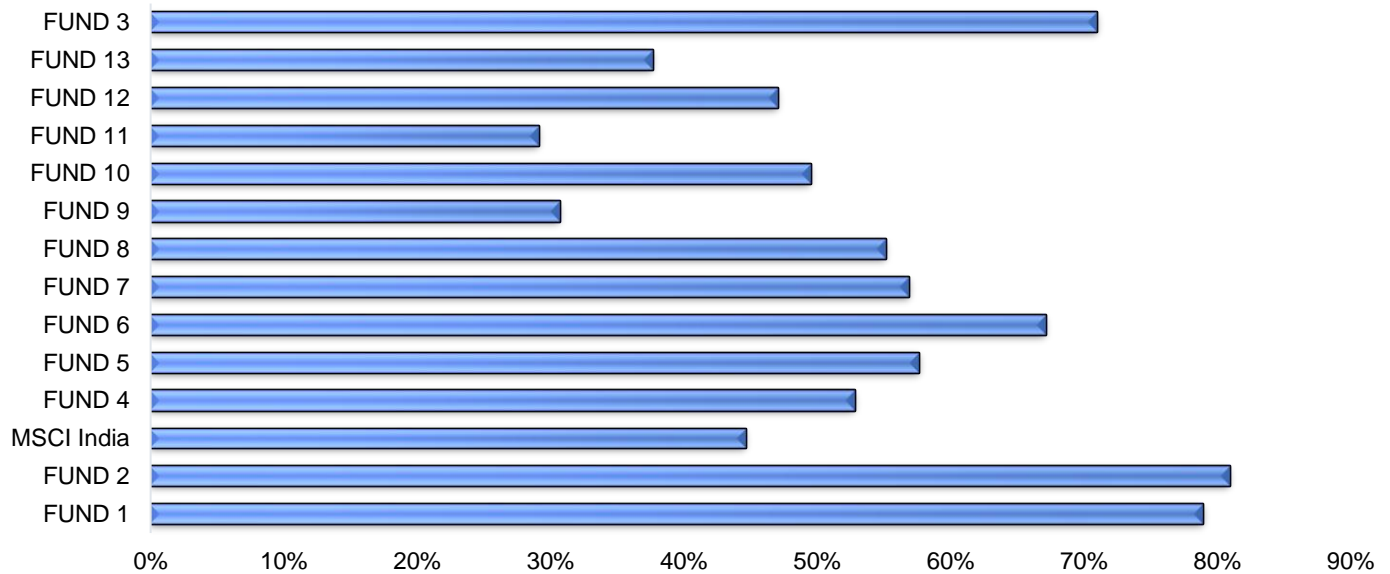
Source: Refinitiv, MSCI

On average, of the percentage of exposure to India, these 11 mega caps were over 54% of the holdings. Across the 13 EM funds the range to these 11 was 29-81% of the Indian exposure. There is a high degree of commonality or “clustering” given the top heaviness of the MSCI India.

From this analysis we make the following high-level conclusions:

- The focus of exposure to India in any case and possibly other economies as well, is on the larger more liquid exposure which tend to be benchmark heavyweights. EM Funds generally have a high level of benchmark awareness.
- This can create significant biases towards industries which have been successful in the last cycle or provide a recency bias to exposure. In this case there is significant exposure to the Financial Sector, expressed by Private Banks (benefitting from weakness of Government owned Banks over the last decade) and Non-Bank Financials (easier regulatory norms than Banks). Technology stocks (also a beneficiary of 30 years of rising outsourcing to India) and Consumption stocks (after a decade of success these companies all trade more than 40x, making India's indices appear expensive) also dominate).

Weight of the 11 stocks as a % of India holdings



Source: India Avenue Research, Refinitiv

And while the narrative of holding India in your portfolio as an investor holds strong in this situation, perhaps EM funds are failing to take full advantage of India’s growth opportunity due to benchmark awareness and the nature of the Emerging Market product structure.

6. India Performance within EM Funds

While these Emerging Market funds tend to prioritise large cap stocks to minimise benchmark and liquidity risk, India only funds tend to have a greater bias towards mid and small caps, seeking to benefit from the establishment of new addressable markets and businesses at an earlier stage of development.

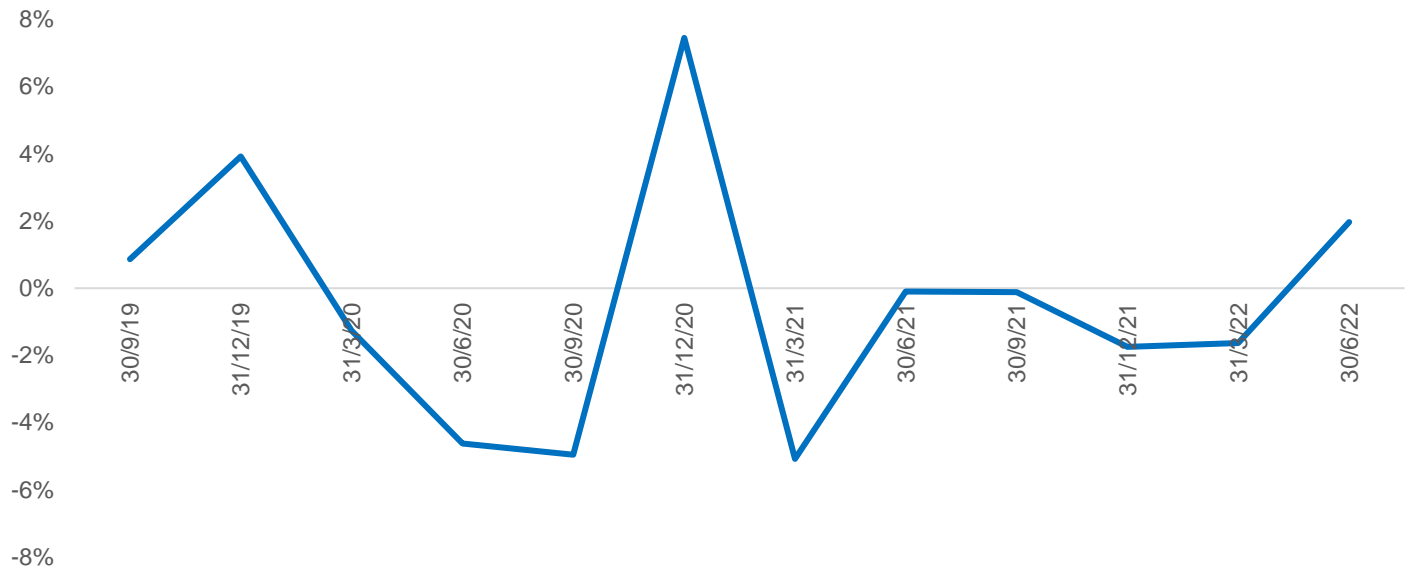
For example India’s largest hypermarket operator, Avenue Supermarts, still have about 22% market share of organised grocery retailing, with organised retailing still being around 10% of overall retail. A buy and hold approach from an early stage, despite valuations, is likely to be driven by knowledge of local retailing, regulations and competitive thrust.

Thus we examined the performance of Indian exposure across the 13 EM Funds over the last three years. Are these some of the best companies in India, driving the benchmark higher through narrow leadership (given they are already over 50% of the MSCI India)?

We took the India portfolio of each EM Fund and made it into a separate sleeve (same weightings) and compared that to the performance of the MSCI India. The underlying results over the last 3 years indicated that most funds are achieving similar returns to buying the index in a country like India.

We can make a high-level assessment that the EM product structure lends itself to benchmark like country weighting and large cap like stock weightings to avoid significant country risk and significant stock specific risk. However, a by-product could be sector / industry risk due to mega-cap industry clusters in various regions.

Performance of India Component of EM Funds vs MSCI India



Source: MSCI, Refinitiv, India Avenue Research

Relative over the 13 quarters over MSCI India was a cumulative -4.05%. This means that although these funds experienced the benefit of India's stellar returns over the period, they were, on average underperformed the MSCI India. This is also on a gross of fees basis. After fees the impact would be more significant.

7. Our Conclusions

It is our view that Emerging Markets were a term coined to separate the broad grouping of Developed Economies/Markets from Developing Economies/Markets. The MSCI's classification separated these equity market subsets by group economies based on the level of development, regulation, political stability and currency volatility rather than mature growth vs high growth.

However, once the MSCI Emerging Markets benchmark was constructed, it provided investment product manufacturers an opportunity to leverage their capability further with their existing labour infrastructure. Several investment teams were based in financial centres rather than deep diving into local economies with locally based analysts.

As a result the outcome of Emerging Market as an asset class tends to focus on exposure to a majority of the constituent countries and an investment amongst the top 15-20 companies ranked by market cap within each country. This was especially the case as funds grew larger and less flexible due to their capacity.

So for investors seeking to get exposure to the structural growth story of India over the next 20 years, in our view it makes sense to consider the following:

