Enduring Pain before Gain in India

Introduction

We entered a far more volatile investment environment due to the pandemic and ensuing supply chain difficulties, disruptive trade, higher commodity prices, war, rising inflation and a corresponding tightening of monetary policy by Central Banks. It is our view that markets will continue to remain volatile until we find the new higher equilibrium interest rate, which strikes a balance between growth and inflation.

Given this environment, the last 6 months have been a difficult phase for equity markets. In this context, we thought we would discuss the outlook for India, Indian equities and our investor proposition to harness India's growth story through the India Avenue Equity Fund.

Who we are?

India Avenue Investment Management is a boutique investment firm, focused on India as an investment destination. The firm is headquartered in Sydney, Australia and its client base consists of Australian and New Zealand domiciled Family Offices, HNW, Financial Planning clients and Direct investors. The firm's core investment proposition is a long-only equity fund, with approximately A$65m in assets. The Fund has a Recommended rated from research rating house Lonsec and now has a track record approaching 6 years. The Fund appears on several investment platforms in Australia and New Zealand.

Our Competitive Advantages

India Avenue's competitive advantages are being a focused, subject matter expert who can impart knowledge and insights to its clients on the following:

- Why consider India in a portfolio and the role the allocation plays in that portfolio,
- Thoughts on investment allocation sizing and timing,
- The appropriate exposure to the region, and
- An optimally packaged investment solution, purpose built for investors from this region

There is no other investment manager based in Australia who is focused only on India. Our competition either replicate indices or are largely benchmark aware, provide similar exposure to Indian stocks held in Global, Emerging Market or Asia focused funds (mega caps) and tend to focus on other products when India is not in favour or there is investor momentum elsewhere.

Our Investment Proposition

The proposition of the India Avenue Equity Fund is built from insights of our founder's multiple years of experience investing in India's equity markets.

1) India is a high GDP growth region relative to other Developed and Emerging Market economies. It should end the decade close to being the world's third largest economy and with a market cap of well over US$5tn, likely placing it as the third largest stock market

behind the US and China. The underlying fundamentals of India provide a significant backdrop for companies to thrive and offer continuously compounding earnings growth as addressable markets grow at a rapid pace.

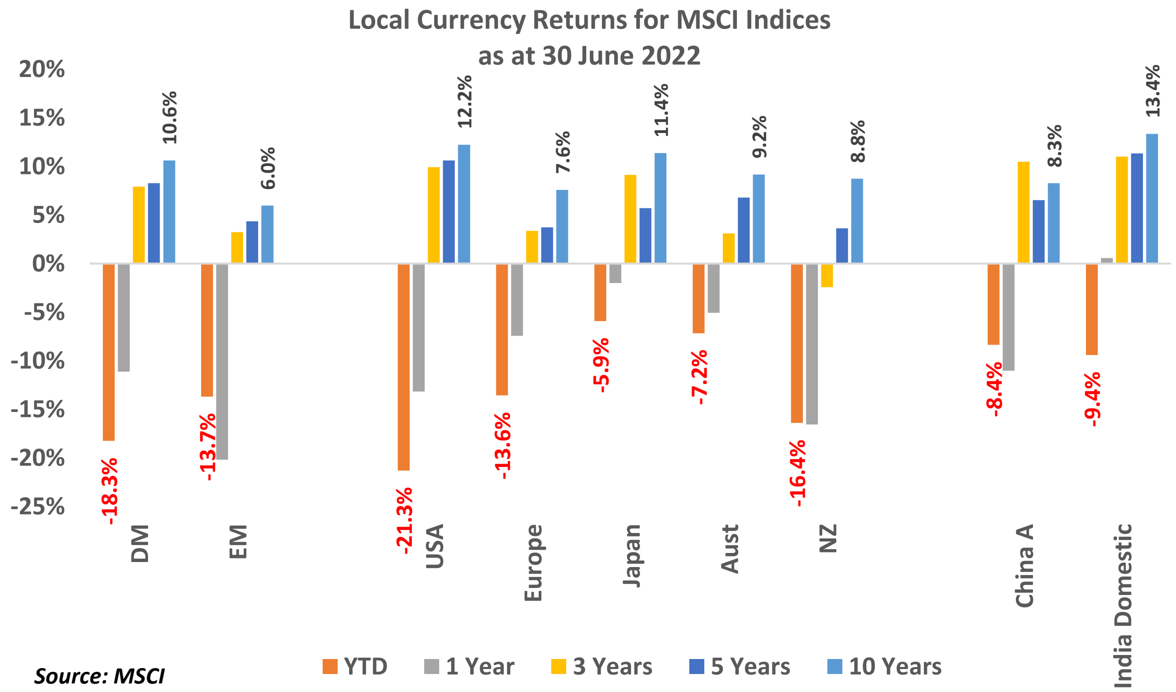
2) Equity markets in India are inefficient, providing opportunities for active investors to add value over investing passively or closely replicating a benchmark in the long-term. Typically the growth and quality style of investing in India has provided long-term outperformance relative to market cap weighted benchmarks.

3) Locally based investment managers have an advantage relative to globally based funds trying to pick stocks in India. The Top 50 stocks in India are amongst the most broker-covered companies in the world (local and global broker research). However, once you go below the top 100 the broker coverage becomes sparse and primary research and localised knowledge of the corporate ecosystem and "founder business ethos" add value over time.

4) Our philosophy on ESG is applied to the Fund at this stage by negatively screening out "harmful sectors" in India, rather than generic rules applied globally. India's companies and reporting is still nascent, and we look to evolve our process as data transparency improves. A rule has now been passed that the Top 1000 companies must report on ESG parameters across a consistent framework, which allows for more positively based filters to be embedded in future.

Indian Market Performance

Indian markets have fared relatively well over the last 12 months, 3 years, 5 years and 10 years relative to other regional markets or compared to broad asset classes like Developed Market Equites (MSCI World) or Emerging Market Equities (MSCI EM).

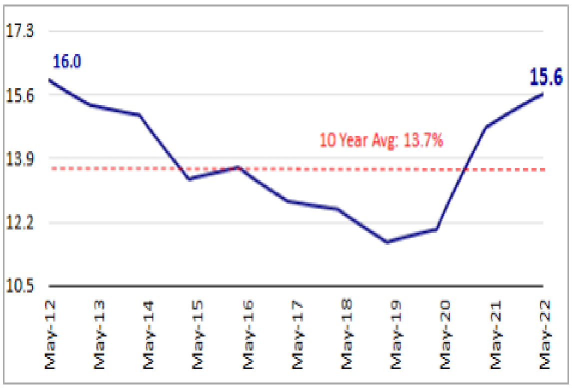


Source: MSCI

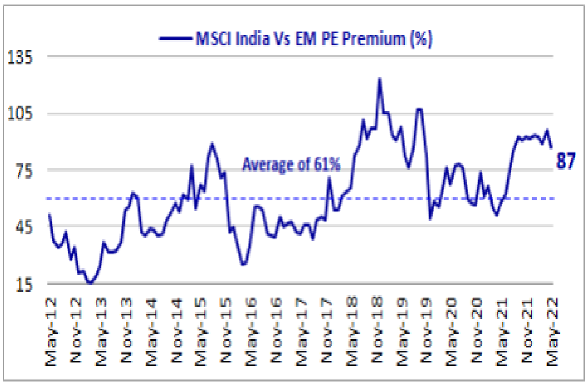
The table above illustrates the returns generated in local currency terms by asset class, region and country. India has fared well across most time periods despite experiencing some drawdown thus far in 2022. Typically, during periods where oil and food prices rise, India tends to fare relatively poorly given the more significant impact of these factors on inflation and its impact on the economy relative to other regions.

The underlying fundamentals of India continue to drive GDP growth and corporate earnings. The 2010-2019 period saw faltering earnings and weaker GDP growth. However, equity markets produced decent returns as P/E's rose globally (given lower cost of capital). India established a significant premium valuation to other Emerging Markets due to its fundamentals (refer chart).

12-month forward Nifty RoE (%)



MSCI India v/s MSCI EM – P/E premium (%)



Source: Motilal Oswal

Outlook for Indian equity markets

Over the last 10 years markets were driven higher by low interest rates and abundant liquidity which provided the justification for a rise in P/E's. However, over the course of the next 3-5 years we are likely to see less liquidity in the system due to a higher equilibrium for interest rates. In this environment, sustainable earnings growth is far more likely to drive markets.

At some point in the next cycle India will benefit from taking a greater share of global economic growth. Equilibrium inflation and interest rates will be higher than zero but low on an absolute basis. India in this environment should generate a greater share due to:

- Increasing productivity through reform and infrastructure,
- Operating leverage from diversifying supply chains and rising global economic prominence,
- Greater focus and incentivisation on local manufacturing and export performance, and
- Local demand driven by financialisation, digitisation and formalisation of the economy.

As capacity utilisation rises towards and above 80%, it is likely that capacity is added to meet increasing global demand directed towards India. This should see the emergence of the next capex cycle. Indian companies have used the last 5-7 years to deleverage as capex was kept to a minimum while demand was dormant. Post COVID-19 significant cash flow generation by businesses have been used to reduce debt, allowing scope for corporate activity and capacity build.

India Avenue Equity Fund Performance

Period	Dates	No. Of Days	Market Behaviour	Mkt Return	Out Perf
1	6 Sep 2016 – 24 Nov 2016	81	Market fell significantly after demonetisation was announced in India	-11.3%	2.2%
2	24 Nov 2016 – 31 Dec 2017	402	Broad market recovery and rally	36.5%	1.1%
3	31 Dec 2017 – 21 Aug 2019	598	Narrow rally. Top 15 stocks are up 30%, Market up 2% and remainder down over 30%. Low breadth rally on economic slowdown, risk aversion	3.8%	-11.1%
4	21 Aug 2019 – 31 Jan 2020	133	Corporate tax reform, rate cuts	11.4%	2.9%
5	31 Jan 2020 – 30 Apr 2020	90	COVID-19	-17.6%	-6.8%
6	30 Apr 2020 – 31 Jan 2021	276	Emergence from Lockdown, Economic Recovery, FII Inflows	20.4%	4.9%
7	31 Jan 2021 – 30 Jun 2021	150	Second Wave	17.6%	7.1%
8	30 Jun 2021 – 31 Dec 2021	225	Earnings Upgrades, Economic Recovery II	16.0%	4.6%
9	31 Dec 2021 – 30 June 2022	211	Rising Inflation, Escalating Conflicts, Oil Price Surge	-10.4%	-8.7%

Our portfolio is set to outperform the benchmark going forward given our focus on quality and earnings growth. When the next "investment cycle" commences we expect it will benefit our positioning. We expect Period 9 will see some degradation of alpha given it's a risk-off environment where the growth style may be compromised in the short-term. Our portfolio has not liked periods where India's growth story is compromised. This periods are cyclical in comparison to the structural long-term growth story. It is our view that market return to normal "growth-seeking" behaviour over medium to long-term periods. Our strategy is set to benefit from these periods.

The table above highlights that our proposition is not in structure or approach conscious to the construct of the MSCI India (a commonly used benchmark for foreign investors investing in India). Our proposition focuses on the growth story of India and seeks to dig a little deeper down the capitalisation curve to find opportunities with segment leaders in less established, but with the potential to growing significantly. This compares to the benchmark which reflects large exposure to companies whose growth opportunity is broadly already understood by the marketplace, with lesser likelihood of mispricing.

India Avenue Equity Fund vs MSCI India

1) Underperformance of the Growth Style

Growth stocks across the globe have seen a significant de-rating in the face of rising inflation and a corresponding shift in monetary policy. It is our view that the Growth style outperforms over time as investors seek to buy and hold companies' growing at above the rate of GDP. We are comfortable with underperformance on account of this factor. It is our view that investors will return to this style when investing in Indian markets. Over the last 9 months foreign investors have reduced their exposure by over US$40bn and are now largely underweight India. We expect this to change as oil prices recede and inflation becomes more benign.

2) Outperformance of Reliance, Adani and SOE's

Several stocks which have driven underperformance of the fund include those which are perhaps more questionable on their Corporate Governance and Environmental issues (Fossil Fuels, Tobacco etc). The Adani Group of stocks have propelled founder Gautam Adani to the 5th richest man in the world, however, are yet to be earnings generative and have low financial transparency. Additionally several Government owned utilities have also prospered over the last 6 months, given the significant need for energy during economic recovery and ensuing shortages. Government owned companies in an economy like India always have the overhang of potential changes in regulations, laws and business economics – thus we tend to avoid them.

These stocks equate to a whopping 20% of the MSCI India and are not the domain of the growth, quality or ESG investor in Indian equities.

	Returns 6 months to 30 June 2022	MSCI Weight
ESG Issues (Governance, Environment)		
Reliance (Fossil Fuels)	9.6%	11.21%
Adani Green	45.1%	0.94%
Adani Transmission	42.1%	1.01%
Adani Enterprises	28.2%	0.94%
Adani Ports	-8.0%	0.53%
Adani Total Gas	39.0%	1.00%
Adani Power	163.6%	0.31%
ITC (Tobacco)	25.4%	1.29%
Government Owned		
NTPC (Power, Coal)	14.9%	0.83%
ONGC (Refining)	6.4%	0.50%
PowerGrid (Power)	3.7%	0.99%
Coal India (Coal)	27.1%	0.43%
Total		19.98%
MSCI India	**-9.96%**	

Source: Refinitiv, MSCI

3) Underperformance of small and midcaps vs MSCI

	Return 6mth to 30/6/22	MSCI Weight	IAEF Weight
S&P CNX Nifty	-9.07%	75%	41%
S&P Nifty Next 50	-13.53%	15%	12%
S&P Nifty Mid/SmallCap	-14.53%	10%	47%

Source: Refinitiv, MSCI

Mid and Small Cap stocks have underperformed over the last 6 months as risk sentiment has turned negative considering the environment. We see the environment as being cyclical in nature rather than structural and are positive on the positioning of the fund on a longer-term basis.

Several of India's best growth stories emerge from outside the Top 100 stocks by market cap. Whilst we appreciate some of the Top 100 are likely to exhibit strong growth, representative of India's comparative advantages and scale (Technology, Financial Services and Consumption), our proposition is focused on finding mispriced growth opportunities in the second tier of market cap. Several of these companies have low broker coverage and lower levels of institutional investment, which we seek to take advantage of over the longer-term. Importantly, they are also not the stocks Emerging Market or Asia fund investors would typically own due to liquidity and lack of primary research coverage. Our nimbleness and size allow for us to provide this exposure to Australian / New Zealand clients, which is likely to be complementary to existing Emerging Market / Asia exposure they hold and broadly also portfolio additive from a risk-return perspective.

India Avenue Equity Fund - Outlook

It is our view that both investing in India and our fund positioning and proposition now appears attractive. We apply the following logic to this statement:

- Foreign investors have deserted India over the last 9-months will return. This is illustrated in the graph below (Emerging Market managers), which is after a decade long overweight stance. However, overall allocation has increased as India has approached close to 13% of the MSCI EM. Additionally, cash levels at funds are also at a significantly higher level indicating a contrarian positive implication for markets should sentiment improve.

Source: Copley Fund Research

- Local Investors in India are now entrenched equity market investors. Retail/HNW/Mutual Funds have moved from 3% of market cap to close to 20% over the last decade. Equity investing culture has increased as a form of wealth accumulation as the asset base moves from physical to financial. This is reducing long term volatility in equity markets and currency.

- Growth stocks are now more appropriately priced from an entry point perspective. They still deserve a premium given the potential to increase market share as India's increasingly becomes formalised (business shifting from informal to formal). The India Avenue Equity Fund EPS growth expectations on average are 50% higher than the market consensus expectations (24% vs 16% as per our previous research note on "*What Growth Investing means to us*").

- Small and Mid-Cap stocks appear to be cheaper than their Large Cap counterparts and should benefit from improving sentiment as commodity / oil prices recede. The companies we own in this space are generally all profitable and growing earnings at above market rather than higher risk, non-profitable businesses. Rather they are simply smaller as their market is still evolving.

India in a Portfolio

Typically Australian investors have a high content of Equities in their Balanced, Growth and High Growth risk profiles. The buckets of allocations today are usually Australian Equities, Global Developed Equities and Emerging Markets. Some include Global Small Caps and Global Infrastructure, however we have focused on the major 3 for this analysis.

Last 20 years data (monthly returns) in AUD	Return AUD	Risk AUD	Return-Risk
40% Aust, 40% Global, 20% EM	4.3%	11.2%	0.38
30% Aust, 40% Global, 30% EM	4.4%	11.2%	0.39
40% Aust, 40% Global, 10% India, 10% EM	5.0%	11.5%	0.43
40% Aust, 40% Global, 20% India, 0% EM	5.6%	12.0%	0.47
30% Aust, 40% Global, 30% India, 0% EM	6.4%	12.7%	0.50
30% Aust, 40% Global, 5% India, 25% EM	4.7%	11.28%	0.42

The Red Box highlights a potentially good starting point, given there is some exposure to India in EM (13% of MSCI EM). Direct, single country exposure to India via an India-only fund can be a structural long-term allocation to India, while exposure to India via EM is more likely to be cyclical allocation. For example, today EM/Asia managers are reducing their weight to India to underweight, when it is our view that adding from a long-term perspective makes sense.

The more India that is added, the improved prospects for the portfolio. Of course this uses historical risk and return relationships. However, with IMF, World Bank etc continuing to forecast India's GDP growth above its peers and volatility receding in Indian equities, the same should hold true for the next 10 years.

Timing

Typically the best times to add exposure to Indian equities in the past have been after a point of duress in global equity markets. Given India's underlying fundamentals, its propensity to rebound strongly provides an opportunity to increase exposure for strategic long-term investors. These rebounds were witnessed in 2003-2007 (post Tech-wreck / US-Middle East War), 2009 (GFC), 2013-2014 (post Taper Tantrum), 2020-2021 (COVID-19).

Period	Total Return
1/1/2003 – 31/12/2007	458%
1/4/2009 - 31/12/2009	72%
1/1/2013 – 31/12/2014	39%
1/4/2020 – 31/12/2021	110%

Source: Refinitiv, India Avenue Research

Our Disclaimer:

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