



Navigating India's EM Supremacy

Stay Single, Don't Mingle



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EXECUTIVE SUMMARY

If your focus IS NOT ON how you effectively and efficiently gain exposure to India's multi-decade growth story, then you are probably reading the wrong research paper !

- Indian equities present compelling standalone opportunities driven by favourable demographics, infrastructure and robust reforms which are unlocking strong economic growth. Traditionally accessed through Global or Emerging Market (EM) funds, India's unique growth trajectory now warrants **independent** investment consideration.
- EM funds typically lack a tailored approach for Indian equities, prioritising liquidity, access and benchmarking rather than alpha generation. These funds often fail to truly capture **India's unique growth story**.
- EM funds show no consistency in adding value from country selection when it comes to India. A compounding earnings environment, driven by robust underlying demographic tailwinds, is best harnessed by **staying invested rather than market timing**.
- Local fund managers domiciled in India have demonstrated superior alpha generation in stock selection compared to EM funds, due to their **focused understanding** of India's structural growth, regulatory structure, significant family ownership and government policy.
- India's mid and small companies (SMID) exhibit **robust EPS growth**, averaging 27.9% and 23.5% p.a. respectively, offering substantial growth and alpha potential beyond the traditional large-cap focus and prioritisation of liquidity by EM funds.
- Indian equity markets offer **significant multi-bagger opportunities**, with 54% of NSE 500 stocks delivering over 10x returns in a 5-year period. This aligns with local fund managers' ability to identify early-cycle, high-growth stocks, with compounding earnings potential.
- EM funds typically concentrate on large, liquid stocks in the Financial Services and Information Technology sectors, while India-only funds have a broader focus, including SMIDs in emerging sectors like Healthcare, Consumer Durables, and Capital Goods. This differentiation **enhances the alpha potential** in high-growth, underrepresented segments in the benchmark.
- In conclusion, an **India-focused investment approach implemented via a single-country fund structure** offers a superior opportunity to harness India's economic momentum, achieve consistent alpha, and strategically capture growth across diverse market segments.

INTRODUCTION

The exploration of Indian equities as a standalone asset class in multi-asset portfolios is indeed a complex topic. Traditionally, investors have accessed Indian equities through Global, Emerging Market, or Asia-focused funds. However, there's a growing recognition of the unique opportunities that Indian equities present, given the region's robust economic growth, favourable demographics, and ongoing reforms.

The challenge lies in the current advice infrastructure of institutions, family offices, investment consultants and financial advice firms, which are unlikely to be equipped to provide the necessary insights and flexibility for a specialised investment approach. This requires a more nuanced and perhaps dynamic approach to asset classes (allocation), and a more informed understanding of regions like India with structural characteristics to warrant consideration as a standalone investment.



In this paper, we test four hypotheses regarding co-mingled investing to gain exposure to India's growth story in comparison to investing using a more focused approach. The ultimate question is:

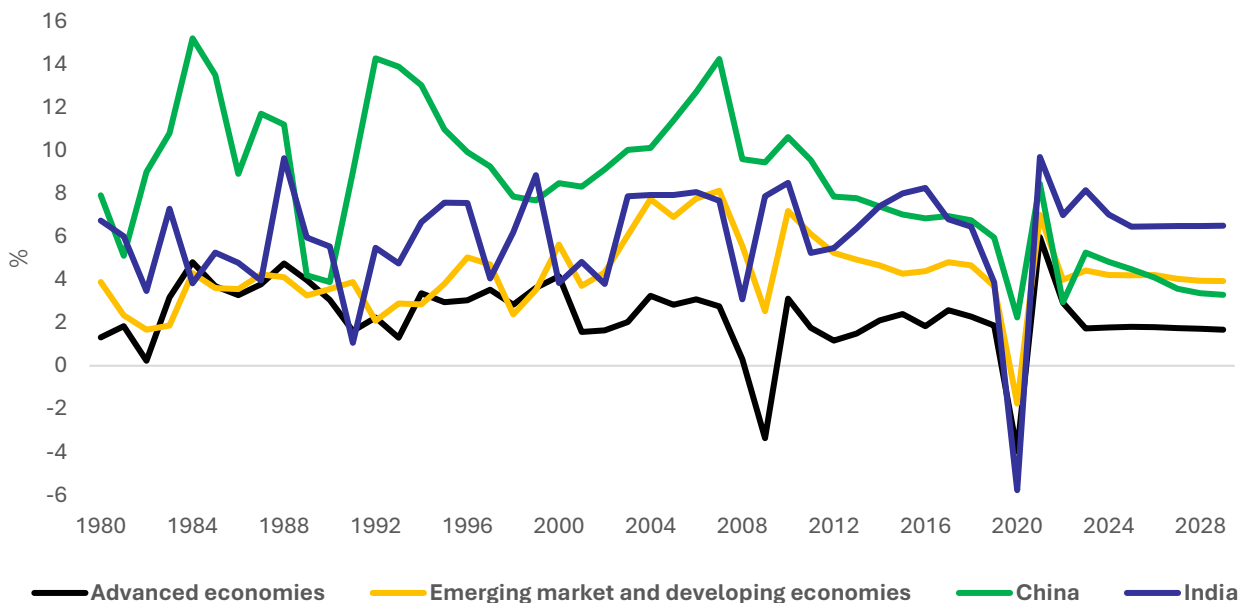
“Am I interested in gaining exposure to India's growth OR do I believe a broad exposure to Emerging Markets will provide a better complement to my existing portfolio?”

HYPOTHESIS I

India's economic growth will be superior to other Emerging Markets over the current decade (and probably the next)

Since 1991, economic reforms undertaken in India have liberalised the economy and have been conducive to building a modernised economy that has become a powerhouse in sectors like Technology, Pharmaceuticals and Services. India's demographic profile of a populous, youthful and aspirant population as well as the further progressive reforms undertaken by the Narendra Modi-led BJP Government (since 2014) has further accelerated GDP growth, particularly since the recovery from the pandemic. The country's economic progress has been resilient, averaging 6.4% real GDP growth over the last 25 years. The IMF is forecasting this growth to persist over the rest of the decade, positioning India as the standout in the G20 group of economies. This forecast is validated by continued progress on incentives and reforms, a rising contribution to the global workforce and increasing urbanisation.

Chart 1 – India's GDP growth superiority over China, EM and DM



Source: IMF WEO, data as of 31/08/2024

Does GDP growth translate into equity market returns?

Whilst India's GDP growth has been robust as illustrated above, does it necessarily mean that it transpires into equity market returns for investors? After all, China experienced a multi-decade growth boom from the mid-1980s to 2010. However, passive investors in China's markets hardly had anything to show for it, with the MSCI China in USD terms, only producing returns of 7.1% p.a. (Jan 2001 – Oct 2024).

Additionally, a study by Dimson, Marsh, and Staunton which sampled 21 countries across 113 years (1900-2013) found a negative correlation between real equity returns and per capita GDP growth (-0.29)¹. Similarly, Northern Trust also undertook a similar study using more countries (43) over a more recent period of 1995-2015². In this study, there was no relationship between real equity returns and GDP growth. The regression indicated that the R² was effectively zero. However, the same research as well as the one undertaken by Dimson et al., illustrated some relationship between forecasted GDP and systematic risk (expectations of variability) of a region to its equity market returns.

Therefore, the findings were more conclusive on forecasted GDP and volatility of the market returns as a link to equity market returns.

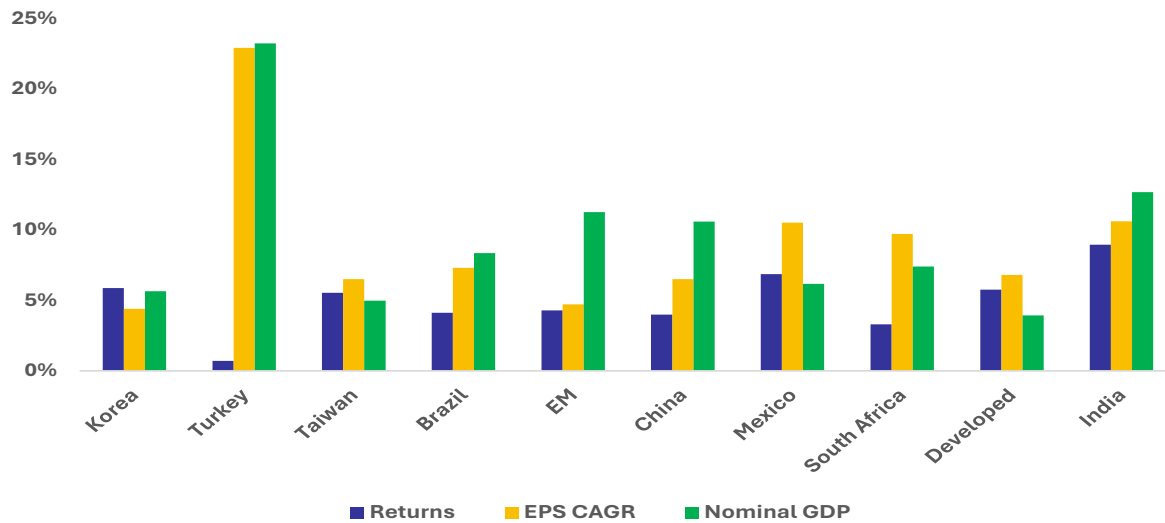
Why we think India will be different

- India's economic growth has been driven by both the public and private sectors. There is also lesser weight in benchmark constituents that can be considered Government-owned.
- The political regime is democratic, which has legal protections, transparency, economic stability, and social investments making it more conducive to higher equity returns.
- The Government of India has undertaken significant economic, regulatory and market reforms since 2014 such as Demonetisation, the implementation of the GST, the application of the Insolvency and Bankruptcy Act, the Real Estate Act, Production-Linked Incentive scheme which have streamlined processes, improved the business environment and provided greater protection for asset owners and as a result, attracted foreign investment (by the likes of Walmart, Google, Facebook, Amazon, Suzuki, Ford, Hyundai, Pfizer etc.).
- Foreign Direct Investment into India has risen from US\$36bn in FY2014 to US\$71bn in FY2024, with rising foreign ownership permitted.
- Finally, India's equity market returns have more or less kept pace with its nominal GDP growth and corporate earnings growth (refer to the chart below).

¹ Dimson et al., London School of Business / Credit Suisse 2015

² Northern Trust – The Enigma of Economic Growth and Stock Market Returns, October 2016

Chart 2 – GDP growth, EPS growth and equity market returns in the last 20 years

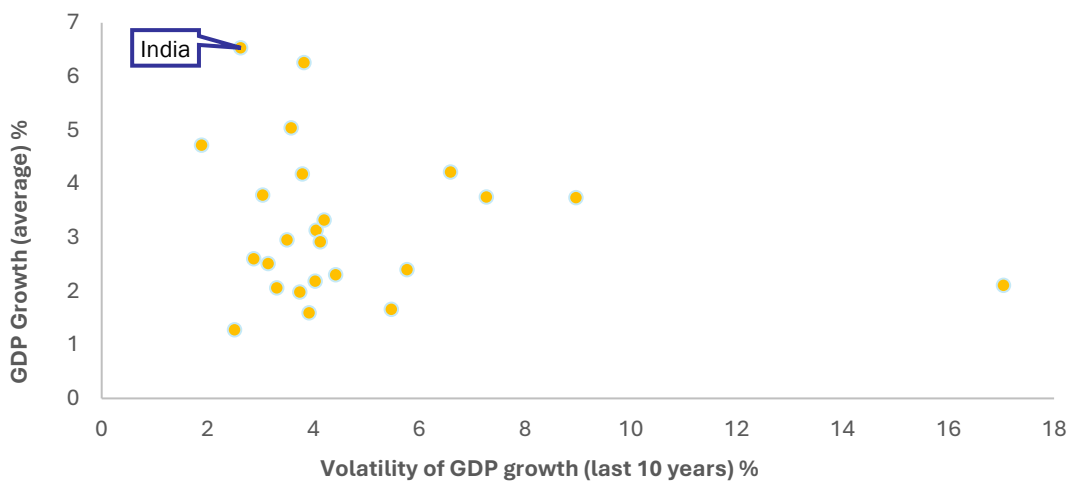


Source: MSCI, Refinitiv, IMF, data as of 31/10/2024

India’s growth is structural

In terms of lower variability of this GDP growth, again India’s growth stands out as a structural long-term story driven by the demographics of the region which is creating a rising demand for goods and services and increasing integration in global supply chains. The low volatility GDP growth of India is illustrated (Chart 3). There are few economies that match the region's structural GDP growth and the depth and size of the capital market. Whilst the likes of the Philippines, Indonesia and Egypt are appealing as well, they don’t have the breadth and depth in the market to make a case for a stand-alone investment.

Chart 3 – Structural growth story = Low Volatility + High Growth

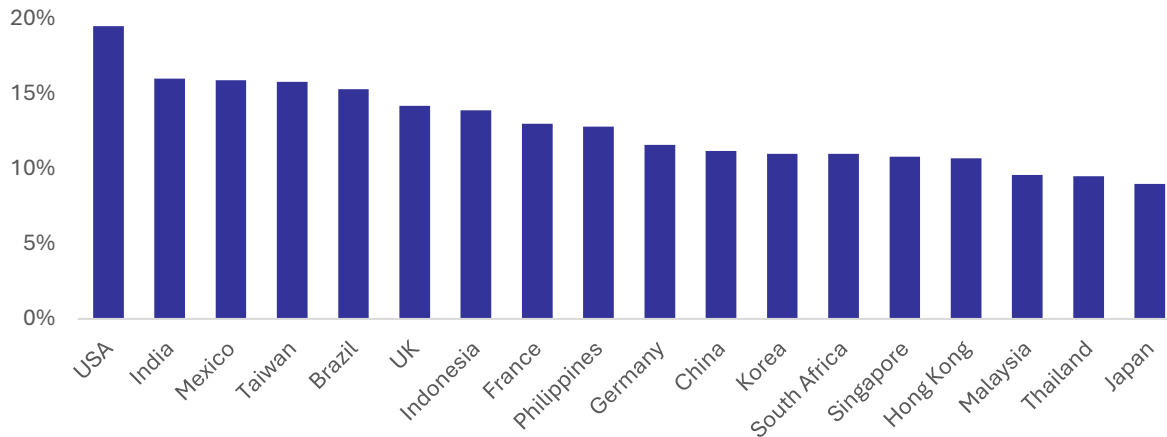


Source: IMF WEO, data as of 31/10/2024

India's superior ROE and earnings growth

India's ROE is second only to the US equity market (in comparison to other major markets), rising significantly over the last 5 years, from 9.8% to 16.0%, forecast by December 2025. However, India's ROE is still well off its cyclical peak of 22%, experienced in 2007 and has considerable upside given operating leverage and capacity utilisation is also off its peak levels in 2010. The US equity market's ROE, on the other hand, is much closer to its cyclical peak.

Chart 4 – ROE Comparison



Source: CLSA, Bloomberg, data as of 30/06/2024

India's Index EPS volatility is also far lower than in other major markets. The country's demographics have led to compounding earnings growth with minimal drawdown. For example, in 2008, 2015, 2020 and 2022, India suffered minimal retraction in earnings due to its unique demographics, local demand and consumption dynamics and the diverse nature of its economy and sectors.

Table 1 – EPS Profile

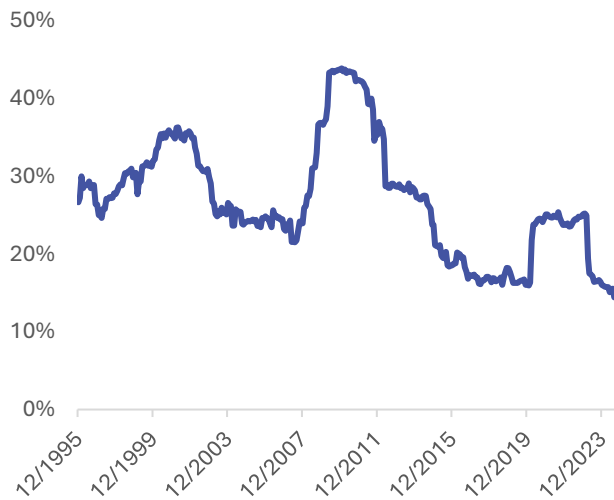
2004-2024	India	USA	Australia	NZ
Annualised EPS Growth %	10.7	7.1	4.2	4.2
Volatility of EPS %	13.6	63.3	69.8	23.7

*calculated by annualised growth over 20 years and volatility in Index EPS as at fiscal year-end

Source: NSE

As a result, share price volatility has also fallen from over 27% annualised (average of 27% over 3-year rolling) to closer to 15% in 2024. This is largely due to a healthy local appetite for structural investment into Indian equities (US\$23bn in CY23 and US\$35bn and counting in CY24). Local investors (retail, HNW and mutual funds) hold a higher weight in India's free float market cap than Foreign Institutions (22%).

Chart 5a – Falling Share Price Volatility



Source: MSCI.com, NSE, CMIE, Morgan Stanley Research, data as of 31/12/2023

Chart 5b – Retail Ownership

Investor Categories	CY23	CY18	CY13
Insurance Companies	5.2%	4.7%	5.2%
Provident Fund	0.9%	0.3%	0.0%
National Pension Scheme	0.5%	0.0%	0.0%
Mutual Funds	6.7%	6.2%	2.4%
Discretionary Port Management	0.8%	0.7%	0.3%
Alternate Investment Funds	0.4%	0.2%	0.0%
Managed Retail Ownership	14.5%	12.1%	7.9%
Direct Retail Ownership	8.9%	8.0%	7.7%
Retail Ownership of India	23.4%	20.1%	15.6%

India's robust macro environment

India's macroeconomic conditions have largely improved over the past 10 years. Its Forex Reserves are now the fourth largest in the world behind China, Japan and Switzerland. This provides an ample buffer against macroeconomic shocks (e.g. rising oil prices) and allows management of currency volatility.

Table 2 – India's Macroeconomic Picture

Macro	Units	Current	10-avg
Forex Reserves	US\$bn	685	483
CAD-to-GDP	%	-0.7	-1.1
Cash Rate	%	6.5	6.0
Exports	US\$bn (monthly)	34.6	27.6
HH Debt-to-GDP	%	42.7	36.7
Disposable Inc	INR mn	296	200
CPI	%	5.5	4.9

Source: tradingeconomics.com, data as of 31/10/2024

India's CAD-to-GDP rose to as high as 5% of GDP when oil prices rose significantly in 2011-2012. The economy was part of the "fragile five". Today, it looks like India might move into a surplus position given its rising exporting prowess in IT Services, Pharmaceuticals, Specialty Chemicals, Textiles etc.

Importantly, India's inflation, cash rate and household debt-to-GDP are not significantly different to where they have been over the last 10 years. Inflation has fallen structurally from above 7% to a range of 4-5%. Mortgage rates are not any higher than in the past – a very different scenario to the Western world.

Finally, the Modi-led BJP Government has been in place since 2014 and is to be at the helm for another 5-year term, ending in 2029. This has led to policy continuity over the last decade which has brought additional stability.

- ✓ **In our view, there is enough compelling evidence that India will be a region that experiences structurally high GDP growth due mainly to its underlying demographics, for at least the rest of this decade.**
- ✓ **Indian equities, as a standalone investment, should illustrate the characteristics of a unique, investable asset class.**



Exposure to India's growth story through EM funds is largely flawed

Once an investor decides they need to gain exposure to India's growth story, there are three main ways they can participate via the country's fast-growing equity market:

- 1) **Global funds:** The exposure to India is minimal as India represents 2% of the MSCI All Country World Index (ACWI) benchmark. This exposure is insignificant and hence we will not analyse these funds in this paper.
- 2) **EM funds:** India is now close to 20% of the MSCI Emerging Market Index, which is a sizeable exposure. In our view, this is the incumbent manner by which most investors have gained exposure to Indian equities given limited infrastructure/knowledge on a deep understanding of individual country's dynamics.
- 3) **Single Country funds:** Investors have 100% exposure to India. However, exposure is differentiated by how benchmark-aware the fund or ETF may be.

The flaws of EM funds

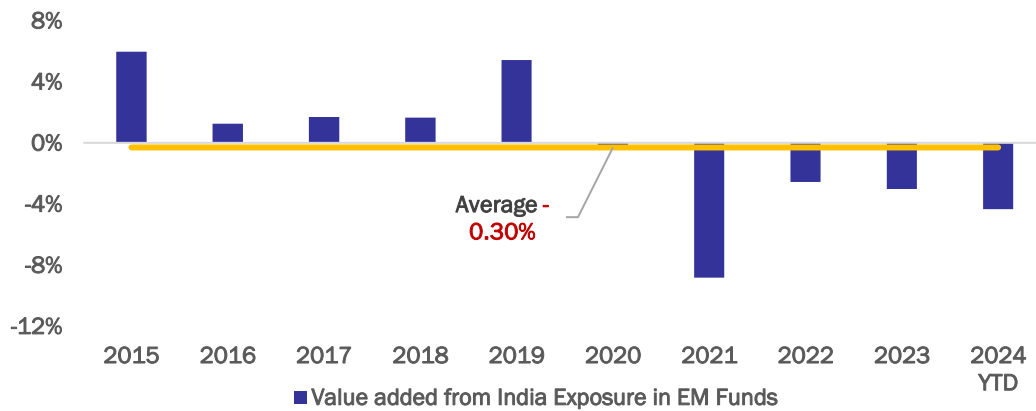
We propose that achieving effective exposure to India via active EM funds (in general) is fundamentally limited. Attribution analysis of these funds indicates that they tend to offer minimal value-add (on average) from the country's selection, market timing, and stock selection. As a result, investors seeking to capitalise on India's growth potential may find an India-focused fund to be the best approach. Our analysis evaluated the characteristics of active EM funds, drawing on a sample of 13 funds that collectively represent nearly 40% of active capital invested in EMs. This approach allowed for a comprehensive assessment of the value-add related to allocations to India, within these portfolios.

EM funds have been inconsistent in adding value from country selection

Over the past decade, the average active EM fund has failed to deliver value through country selection for India, with a 10-year average value contribution of -0.30%. Data further indicates considerable volatility in the value-added, with recent years (2021–2024) reflecting substantial negative value during a period of strong performance in the Indian stock market. This may lead to underperformance during phases of compounding earnings where for example value investors may be disbelieving. This underscores EM managers' limitations in capturing India's bull market phases.

The inconsistency in value addition from Indian exposure through these funds suggests that investors are unable to reliably access India's growth potential via this approach.

Chart 6 – Value Addition from Country Allocation to India in EM Funds

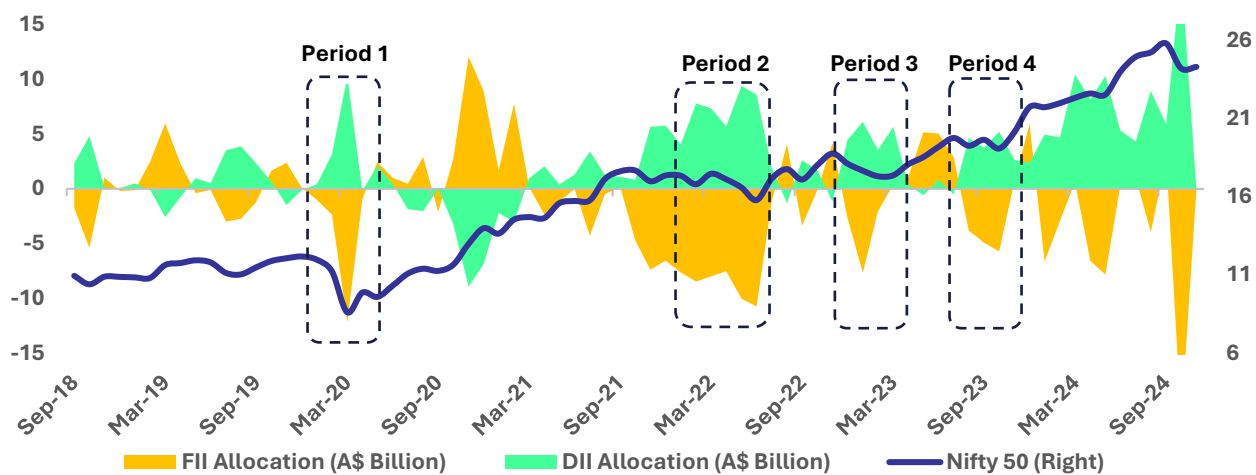


Source: Refinitiv, data as of 31/08/2024. EM fund performance is an average of 13 prominent EM funds

EM Fund’s Market Timing in India has been Less Effective than Staying Invested

EM funds have historically adopted a tactical rather than structural approach to India (given the increased breadth of opportunities), resulting in missed opportunities within this high-growth market. An analysis of EM fund strategies reveals limited value added from timing country selection to India, indicating a suboptimal approach to portfolio weighting. Despite India's robust growth potential, Foreign Institutional Investors (FIIs) and Foreign Portfolio Investors (FPIs) often engage in what amounts to tactical beta plays rather than committing to long-term structural allocations. This section explores the timing and impact of FII entries and exits, comparing their approach with Domestic Institutional Investors (DIIs) who demonstrate a more consistent strategy (given lower breadth also) aligned with India's growth trajectory. By examining historical data on allocations and the performance of the Nifty 50 index, we assess the extent to which FII strategies capitalise on or diverge from market opportunities.

Chart 7 – Nifty Performance vs FII and DII Net Allocation



Source: NSE, data as of 31/10/2024

Notably, FIIs tend to reduce exposure during market downturns, often failing to capture subsequent recovery gains. DIIs, in contrast, increase allocations during these downturns, helping to stabilise the market. Significant market declines (refer to Table 3) reveal considerable DII inflows counterbalancing FII outflows, often preceding a market recovery as the Nifty 50 index rebounds. FIIs, however, tend to re-enter at elevated levels, reflecting a pattern of suboptimal market timing.

Table 3 – Period Net Flows and Performance

Period	FII Allocation A\$bn	DII Allocation A\$bn	Subsequent 12m Performance
Period 1 (Feb 20 – Apr 20)	-15.5	13.3	69%
Period 2 (Feb 22 – Jun 22)	-25.6	22.5	16%
Period 3 (Dec 22 – Apr 23)	-9.4	15.4	34%
Period 4 (Aug 23 – Dec 23)	-9.9	11.6	11% (YTD)

Source: Motilal Oswal (Bulls & Bears), NSE

This evidence underscores the importance of a structural, long-term allocation approach over tactical rebalancing. A strategy that holds through market cycles, akin to the behaviour of DIIs, could allow FIIs to more effectively harness India's sustained growth potential and enhance alpha generation. The benefits of compounding are usually played out over a cycle and require staying invested. FII's often find it hard from a behavioural perspective to re-enter at higher levels, after selling.

EM funds tend to follow benchmark exposure

A regression analysis on EM funds relative to benchmark weights reveals a strong tendency to mirror benchmark index exposures rather than pursue distinct growth opportunities. The regression analysis conducted across the EM fund universe demonstrates a correlation coefficient of 0.87 and an R-squared value of 0.77, indicating a significant positive relationship between fund weights and benchmark weights. This suggests that approximately 77% of the variance in fund weights is attributable to the benchmark's influence.

These findings highlight a close alignment with benchmark allocations, suggesting that investors exposed to India through EM funds are effectively “riding” the benchmark up and down, rather than India's outperformance of EM. In the last 10 years in local currency terms, this has amounted to 165% (as of 31 October 2024).

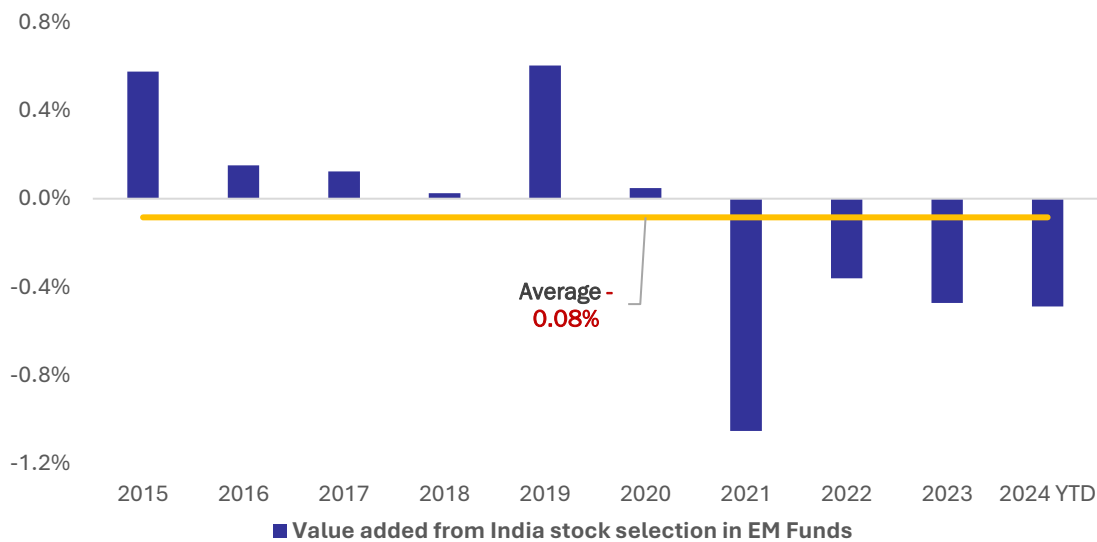
- ✓ **In our view, there is compelling evidence that EM funds (in general) have not added value from timing allocations to India relative to their benchmarks. Our analysis of their exposures to other regions highlights similar behaviour, with country allocations often mimicking Index weights over time. Would it be worthwhile to consider “front-running” the Index weight to India, by adopting a strategic overweight, which wasn't rebalanced or re-weighted?**

HYPOTHESIS III

EM funds add minimal value through their stock selection in India

EM funds generally adhere to mandates that emphasise liquidity over alpha generation, often resulting in benchmark-aware stock selection. Over the past decade, data shows that stock selection in India by EM funds has generally not added value, with particularly significant negative contributions from 2021 to 2024 — a period marked by the strong performance of Indian equities. This underperformance underscores the challenges EM managers face in outperforming a passive allocation during bull markets in India. This is usually a phase where SMID investing is likely to prosper, with greater depth required to harness outperformance.

Chart 8 – Value Addition from Stock Selection (India) in EM Funds



Source: Refinitiv, data as of 31/08/2024. Our EM sample is an average of 13 prominent active EM funds

Many EM funds (FPIs) concentrate their allocations on the most liquid, large-cap stocks (top decile) within the index, limiting their ability to generate alpha. This approach reflects a beta-driven strategy, closely mirroring market movements with minimal deviation in stock or sector exposure. Analysis indicates that alpha-rich opportunities reside primarily in stocks between the 4th to 6th deciles, where FPIs hold minimal positions, missing out on this potential for enhanced returns.

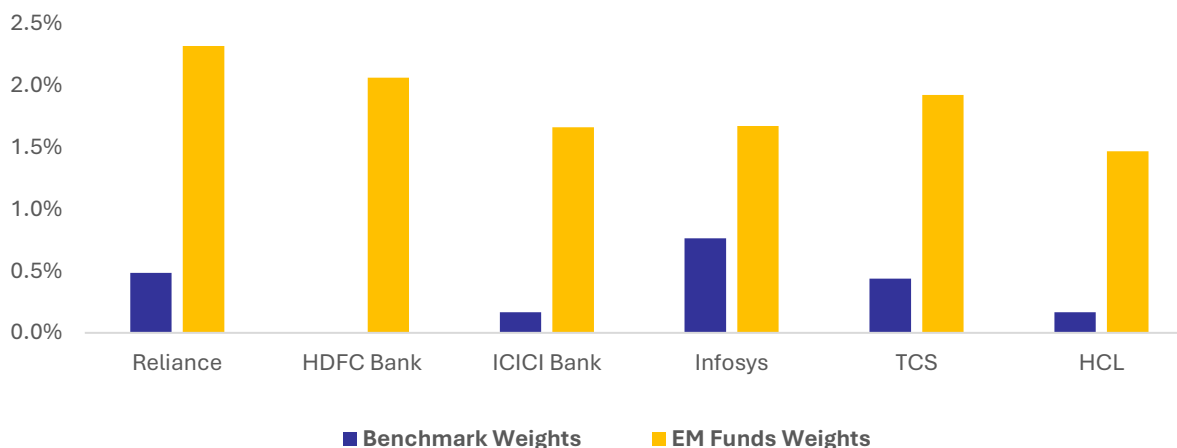
Table 4 – FPI vs Domestic Mutual Funds vs Individual Investor Market Cap Allocation

Deciles	Foreign Portfolio Investors	Domestic Mutual Funds	Individual	Total Market Cap
1	88.4%	79.5%	65.2%	79.0
2	7.7%	13.8%	14.2%	11.2
3	2.5%	4.2%	8.8%	4.7
4	0.9%	1.9%	4.7%	2.4
5	0.2%	0.4%	3.0%	1.2
6	0.1%	0.1%	2.0%	0.7
7	0.0%	0.0%	1.1%	0.4
8	0.0%	0.0%	0.6%	0.2
9	0.0%	0.0%	0.3%	0.1
10	0.0%	0.0%	1.0%	0.0

Source: CMIE Prowess, AMFI, SEBI, NSE EPR

Moreover, when we look at the holdings of EM funds, they are significantly overweight the largest companies in India. In fact, almost 6x the weight of the benchmark weight to the same stocks over the last 10 years. This is highly reflective of their objective to pursue liquidity. This can be quite distinct for a single-country manager who can “dig deeper” on primary research to identify value and growth in the market, whilst being able to manage liquidity from a portfolio perspective.

Chart 9 – 10 Year Average of EM Benchmark Weights vs EM Funds Weights in Largest Indian Stocks



Source: Refinitiv, data as of 30/09/2024. EM funds are a sample of 13 prominent active funds. HDFC Bank was not part of the benchmark for a long period (due to hitting foreign ownership limits), despite being one of India’s largest companies. It presented many EM funds with a relatively easy way to generate alpha through a large liquid stock.

Table 5 – Benchmark Weights vs EM Funds Weights on the Largest Indian Stocks

	1Y		5Y		10Y	
	EM Bmk Weights	EM Funds Weights	EM Bmk Weights	EM Funds Weights	EM Bmk Weights	EM Funds Weights
Reliance	1.38%	3.57%	0.97%	3.08%	0.48%	2.32%
HDFC Bank	0.69%	2.67%	0.00%	2.32%	0.00%	2.06%
ICICI Bank	0.96%	2.63%	0.58%	2.37%	0.17%	1.66%
Infosys	0.97%	1.79%	0.56%	1.18%	0.76%	1.67%
TCS	0.17%	1.38%	0.44%	2.07%	0.44%	1.92%
HCL	0.25%	0.39%	0.14%	1.70%	0.17%	1.47%
Total	4.43%	12.73%	2.69%	13.74%	2.02%	11.55%

Source: Refinitiv, data as of 30/09/2024. EM funds are a sample of 13 prominent active funds

✓ In our view, it is relatively clear that EM funds in general tend to get their exposure to countries like India through large and liquid companies which tend to have higher benchmark weights. These are often companies with significant broker coverage, with minimal value to be added from primary research.

Whilst these companies may be considered “new and exotic” for an EM fund, most are already household names in their own individual equity market and reflect to some extent yesterday’s success stories. Locally based managers are likely to be better placed to identify significant market outperformers.



HYPOTHESIS IV

Indian fund managers outperform EM funds when it comes to stock selection

In Hypothesis II and III, we have presented the flaws of an EM fund and its ineffectiveness in providing any value when it comes to investing in India. In this section, we explore if it is true that local fund managers in India outperform the same sub-index of the MSCI EM (MSCI India) used by EM funds.

India's equity market provides a rich backdrop for alpha generation

As discussed in Hypothesis III, EM funds have added minimal value in general when it comes to stock selection in their India exposure. This is vastly different to the alpha generation environment **for Indian-only funds, with 38% of Indian fund managers able to outperform the benchmark (significantly higher than the US and Australia of 12% and 15% respectively) according to the S&P Global Spivacard June 2024.**

Additionally, Table 6 below shows a significantly higher average annual alpha from Indian fund managers over the past decade, highlighting the Indian equity market's inefficiencies and the potential for outperformance through active, India-focused strategies.

Table 6 – EM vs India Fund Alpha

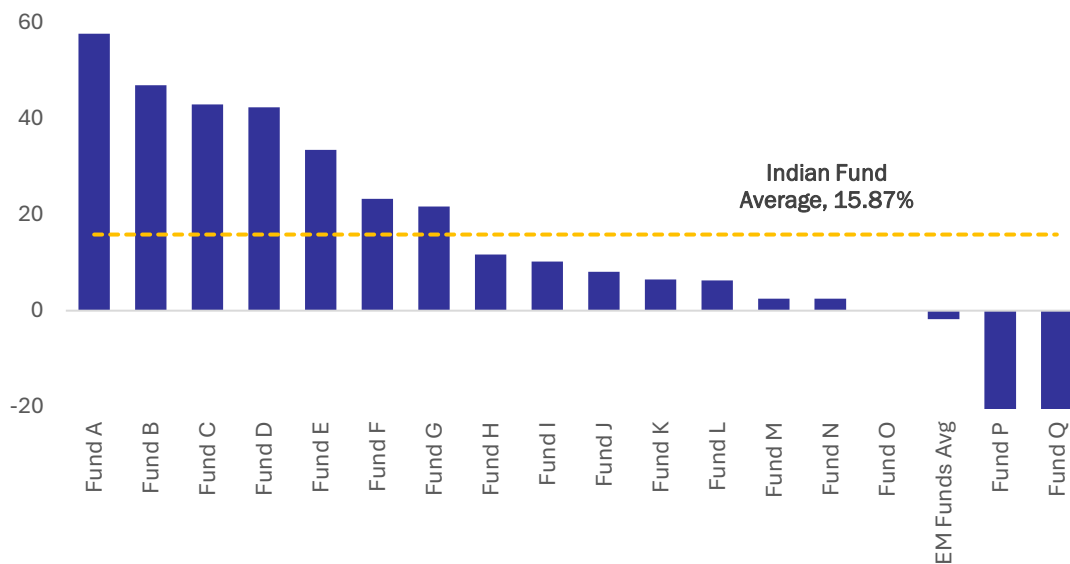
	Average Alpha p.a. (10Y)
India-only Funds	3.70%
EM Funds (stock selection value add)	-0.08%

Source: Morningstar, as of 31/08/2024

It is also important to note that the Indian stock market (Nifty 500 index INR as of 31/08/2024) delivered an average of 12.6% annualised return, which means the **alpha generated by Indian fund managers contributed to more than a fifth of their total returns**, whilst beta (market-returns) delivered the other 80%. This further **highlights the inefficiencies of the Indian market and the need for an India-only fund to translate this into outperformance.**

To further examine the disparity, we analysed alpha generation by EM and India funds over the last three years (2021-2024) during a strong market rally. The average EM fund has not only failed to capture alpha but ranks near the bottom in terms of contribution from stock selection. In contrast, the average India-focused fund generated a total alpha of 15.9% during the same period, underscoring the substantial difference in investor outcomes between the two approaches.

Chart 10 – EM vs India Fund 3Y Comparison – Value Add from Stock Selection

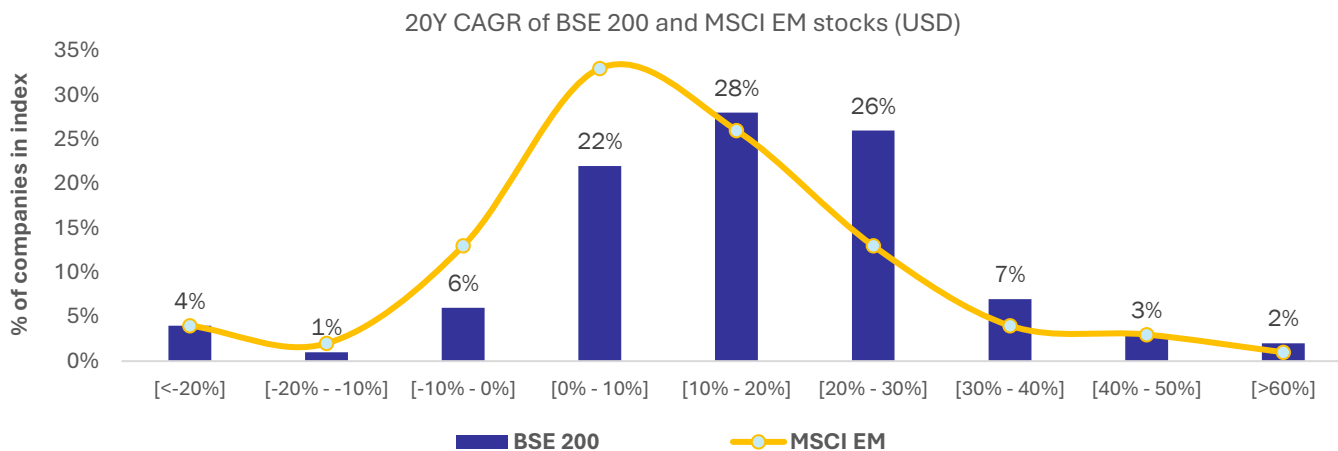


Source: Refinitiv, as of 30/09/2024. Local India Equity Funds 3-year value-add

More multi-baggers in India than in other regions

Over the past two decades, approximately 60% of the current BSE 200 stocks have outperformed their benchmark, with nearly 40% achieving annualised returns exceeding 20%. This is double the proportion found within the broader MSCI EM index, where only 20% of stocks have reached this hurdle. **This superior return profile of Indian stocks, especially in the mid-and small-cap segments, stands in sharp contrast to the MSCI EM index.**

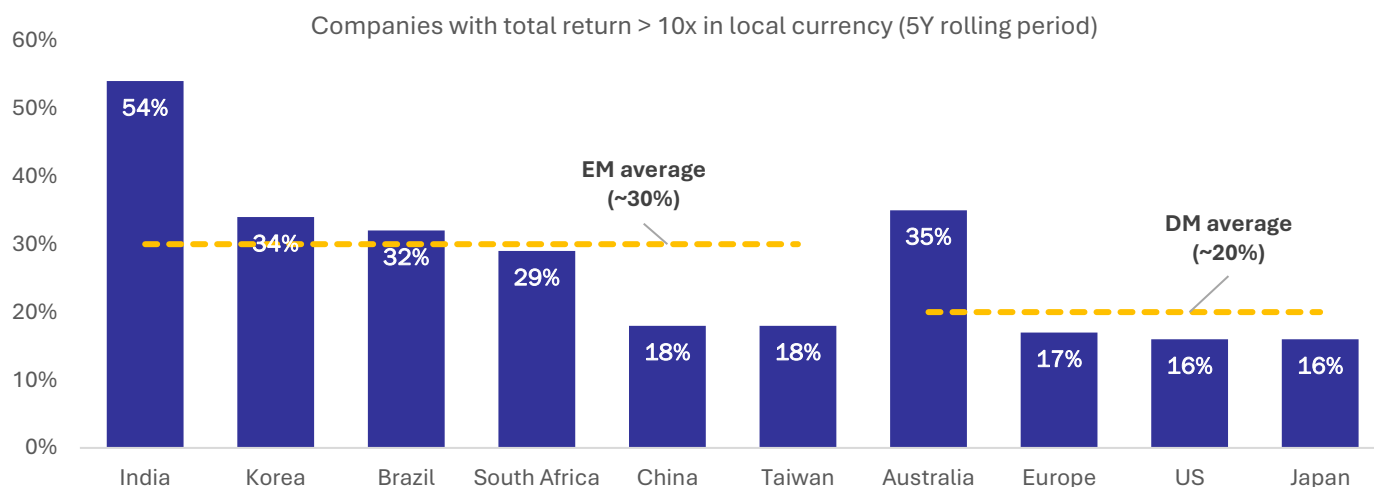
Chart 11 – Percentage of Companies by Price Return in the Last 20 Years



Source: MSCI, Bloomberg, FactSet, Goldman Sachs Global Investment Research, data as of 31/12/23

Additionally, 54% of NSE 500 stocks have delivered over 10x returns within rolling five-year periods since 2000, which is the highest concentration of multi-baggers among the world's 10 major markets. **This environment offers rich alpha-generating opportunities, particularly through early-cycle investments in growth stocks, an area where local fund managers have distinct expertise and insight into family ownership and the evolution of a business from when it was private.**

Chart 12 – Percentage of Multi-baggers Across Markets Since the 2000s



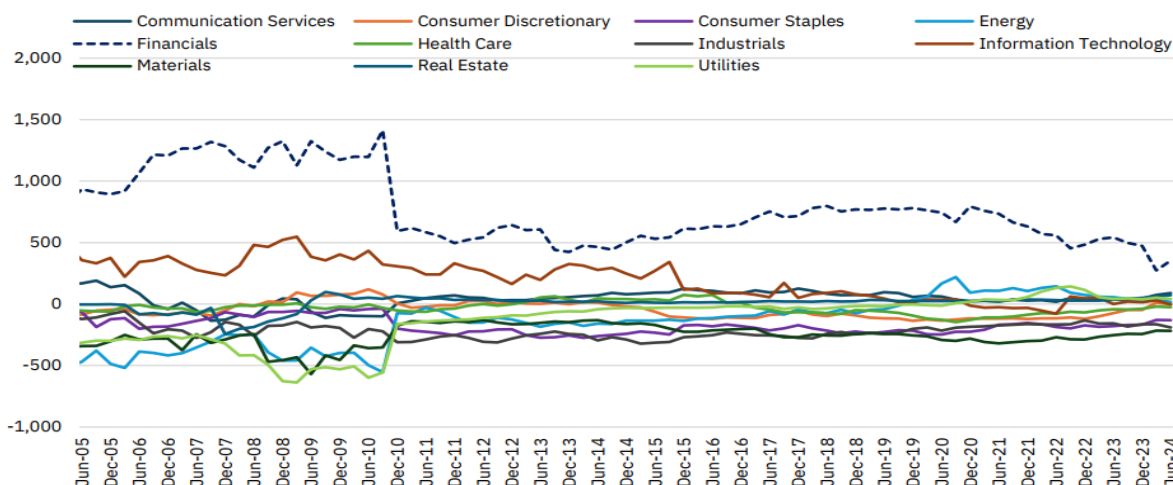
Source: DSP Mutual Fund, data as of 30/06/24

The Indian market's exceptional multi-bagger potential and higher return profile make India-only funds far more likely to outperform the average EM fund, at least when it comes to exposure to India. Focused exposure can capture India's unique growth dynamics in a more effective manner.

Sectoral exposure of single country structure vs EM related products

As discussed in Hypothesis II, Emerging Market (EM) funds are generally benchmark "aware" in their holdings, favouring liquidity and beta exposure over alpha generation. While India presents considerable active management opportunities, especially within mid and small-cap stocks, many EM funds remain concentrated in large and liquid companies and established sectors, primarily Financials and Information Technology. This sectoral concentration, shown in Chart 13, reveals a substantial overweight to Financials among EM funds (represented by FPIs), which limits the exposure to India's diverse economy and growth sectors. Exposure to Financials also limits the diversification to broader global and Australian / NZ portfolios due to their high representation in Financials.

Chart 13 – FPI vs Nifty 500: Sector-wise Overweight and Underweight Trends



Source: CMIE Prowess, NSE EPR, data as of 30/09/24. *FPI ownership includes ownership through depository receipts held by custodians

The sectoral exposure of EM funds contrasts immensely with Indian fund managers with a preference for small and mid-cap companies (SMIDs), which is generally known locally as the alpha “sweet spot” (i.e. A\$0.5 –A\$5bn in market cap). As mentioned in the previous section, Indian funds tend to look for businesses earlier in their cycle to capture the multi-bagger opportunities, with SMIDs being the prime segment to capture this potential growth. As such, EM funds tend to buy the industry/sector winners of yesterday, whilst India-only funds have a greater focus on the winners of tomorrow.

Table 7 displays the top 10 sectors in the Nifty 50 index vs the Nifty Mid Small Cap 400 index, which is a better representation of what Indian funds are holding in their portfolio. (ex-Top 100).

Table 7 – Top 10 Sectors in the Nifty 50 and Nifty Mid Small Cap 400 (October 2024)

Nifty 50	Nifty Mid Small Cap 400
Financial Services (34.3%)	Financial Services (20.3%)
IT (12.9%)	Capital Goods (14.08%)
Oil Gas & Fuels (10.8%)	Healthcare (11.6%)
FMCG (8.2%)	Chemicals (6.9%)
Auto (7.4%)	Auto (6.7%)
Healthcare (4.0%)	IT (6.3%)
Telecommunication (4.0%)	Consumer Durables (4.9%)
Construction (3.9%)	FMCG (4.3%)
Metals & Mining (3.5%)	Consumer Services (3.6%)

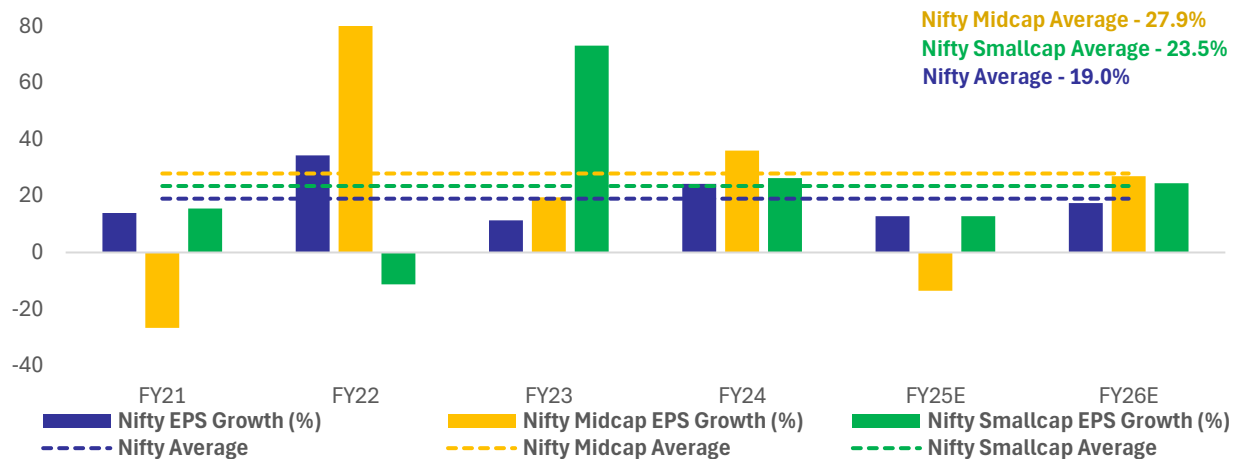
Source: Nifty Indices, data as of 31/10/2024

Better EPS growth in the Small and Mid (SMID) segment

The approach of EM fund managers, along with FIIs and FPIs, which often default to large-cap companies as shown in previous sections, has been driven by liquidity and perceived stability. This overlooks the broader market story in India where growth and alpha sweet spot are.

These segments have demonstrated robust earnings, with an average annual growth of 27.9% for mid-caps and 23.5% for small caps from FY21 to the projected FY26. The robust forecast for the SMID segment, with projected earnings growth of approximately 25% in FY26, highlights the structural growth opportunity within India's broader market. By focusing exclusively on large and liquid companies, EM funds often miss significant alpha opportunities that India-only funds may achieve by being liquidity agnostic and incorporating SMIDs into their portfolio construction.

Chart 14 – Annual EPS Growth for Nifty Large cap, Mid cap and Small cap



Source: Motilal Oswal, data as of 31/10/2024

Some notable key points include:

- EPS Growth since COVID-19 has been greater in Mid and Small Cap segments. However, growth is more volatile and economically sensitive.
- With significantly more names to choose from (India has 5,000 listed stocks, of which the top 1,000 are liquid and investable), the Small and Mid-cap segments have traditionally been a great hunting ground for alpha generators.
- With increasing digitisation and financialisation, several Micro, Small & Medium Enterprises (MSMEs) have thrived by broader reach at a lower cost as a business.
- Government infrastructure initiatives have contributed to the resilience and growth of smaller firms across India.

- ✓ We view that using a single-country structure in India provides a more effective way to capture sustainable alpha by accessing parts of the market that have structural growth. EM products focusing on liquidity, benchmarking and specific sectors lead to suboptimal performance relative to client expectations. Clients tend to prefer the broader structures for convenience and their existing decision-making infrastructure. Returns surely must play a role? Active local managers in India can differentiate themselves from EM managers by pinpointing key market fundamentals such as governance, growth, business cycle, founder mentality, peer group/competitors understanding, supply chain network, regulation, government structure and understanding of early-stage companies.



India-only Funds have More Efficient Operational Structure

Lastly, structuring an optimal operational framework is crucial for effective investment in India. This approach goes beyond mere participation; it involves active investment management and an efficient structure to minimize operational leakages, which can be substantial in the Indian market. Key advantages of a single-country fund model include:

- Funds using a global custodian typically face transaction fees of \$50-70 per trade in India, which can drive up costs for those trading Indian stocks within broader EM mandates. In a diversified fund, these costs may be less apparent as they are spread across multiple markets.
- However, by employing a local custodian, transaction costs can be significantly reduced to around \$15-20 per trade, enhancing cost efficiency and improving returns for India-focused investments. This approach generally delivers a more favourable return experience in comparison to accessing India through broader EM funds.
- Investment models that rely on systematic trading or frequent rebalancing, such as passive or systematic ETFs, generally incur higher transaction costs than actively managed funds or ETFs. By reducing transaction volumes, active strategies within a locally focused framework can offer cost advantages.

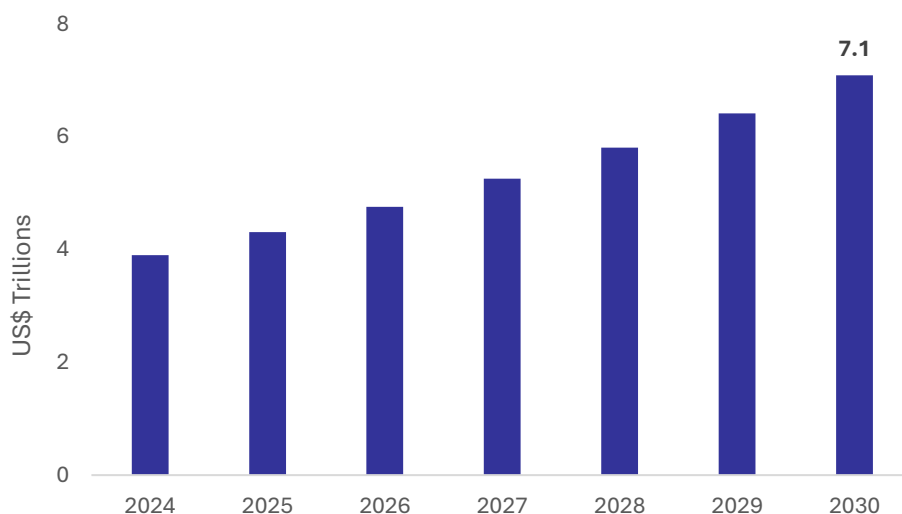


CONCLUSION

India's weight in the MSCI ACWI index is already 2% and is set to grow as the country is in the midst of a structural economic boom which will continue to play out over this decade and most likely at least the next. Within the next five years, investment consultants are likely to entertain a sub-category such as "EM ex-India," like they proposed when China got too big (EM ex-China + single country China fund in 2021 when China was over 40% of MSCI EM).

We view this as inevitable, and investors are better off "fronting" this by having a focused allocation to the world's fastest-growing economy.

Chart 15 – India's GDP Projection



*Source: IMF WEO Database, data as of 31/10/2024. *Growth based on IMF Forecasts for India's real GDP Growth plus the addition of RBI target inflation rate of 4%*

With India's nominal GDP forecasted to reach US\$7 trillion by 2030, its stock market is also expected to grow at a comparable rate, potentially reaching US\$10 trillion in size, doubling its current market capitalisation. The opportunity to benefit from growth in the most effective manner in our view, is via investment in an India-only fund. This can be considered as a complement to an EM fund (to increase the strategic allocation to the region) or as a stand-alone replacement for an EM fund (for longer-horizon investors).

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