Regional Investing – What we have learned

Investors in Australia and New Zealand have long avoided investing in specific regions, countries, or themes. It is often perceived to be too difficult to get timing right and the advice from consultants and "experts" is generally to leave it to highly skilled fund managers to make the decisions on these factors i.e. do we need to invest there and if so how much and why. **Regional investing is perceived as difficult for investors**.

The logic as to why it is difficult is generally associated with additional volatility of these investments, foreign currency risk and most of all, the lack of information or transparency. Investors who have attempted to do this on have often failed due to their psychology rather than appropriateness. They tend to **buy when everything looks positive and boom is priced in and sell when everything looks negative and gloom is priced in**.

In our four years of managing a regionally oriented investment (Indian equities) at India Avenue we note the following observations:

- Investors are **overly focused on timing and getting the regional call right**. This is especially the case as increased scrutiny may fall on peripheral investments (particularly if advising clients). This **focus on timing usually leads to an incorrect decision**

- Investors continually make the **mistake of thinking they are investing in "India" the country rather than companies listed in India.** Whilst companies may be benefitting significantly from the fundamental tailwinds of the country, there will be a lot of dispersion between how company share prices fare. If I am an investor in Australian stocks, then am I buying Australia or CSL vs ANZ vs BHP?

- **Investors look at macro issues and use an all-encompassing paintbrush to taint the overall investment.** Yes, is it true that India has lots of people which is not ideal for a fighting a pandemic. However, not all companies in India will fare the same. In fact, some will use it to thrive, gain market share and become a stronger business i.e. pharmaceuticals.

<u>Compounding Growth is Structural</u>

In India, out of 6,000 listed companies, several are investable and are compounding earnings or have the capacity to due to economic fundamentals (young working age population), market positioning and brand, an economic and financial moat and the tailwind of being significant within a growth industry.

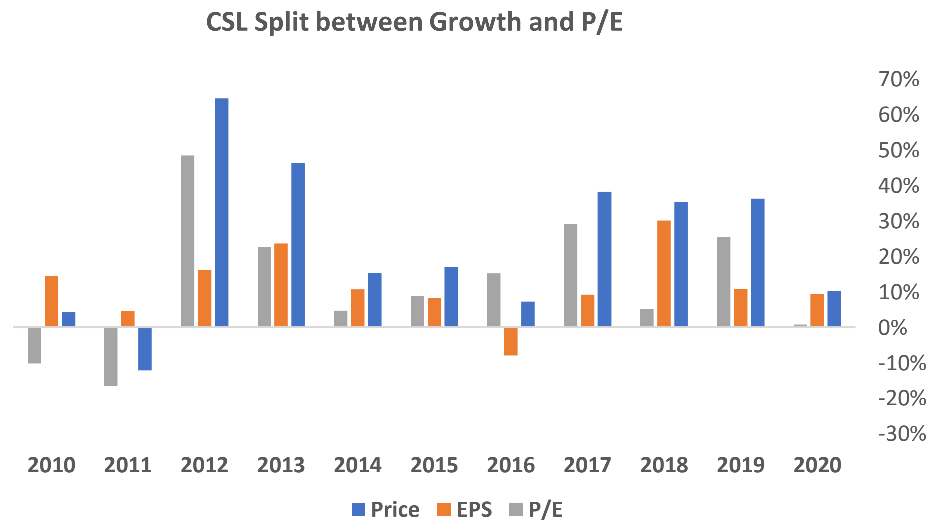
The trend in India over the last 20 years have been a gradual shift towards an organised economy. An example is the gradual shift towards organised retailing from disaggregated one store models. This is reflected in profit concentration with the top 2 players across industries now holding dominant profit share. The pace of this change has been accelerated by tax reform, financialisation (everyone having a bank account) and digitalisation (everyone having a smart phone).

This has meant **that those being able to identify a growth industry and strong players within that industry have generated far higher returns than the market return** which include inefficient, government owned companies, cyclically oriented industries, and companies making poor capital management decisions.

An Australian example

Investing in CSL over the last decade has provided a far superior experience to investing broadly in an Australian Index Fund. That is due to CSL's technical expertise which is its moat resulting in strong compounding growth. Investors have been willing to afford it a significant premium due to its compounding growth relative to more cyclical or lower growth businesses. CSL will remain a premium P/E business until its growth slows to a market level of growth.

Over the past decade CSL generated 11% earnings growth compounded and averaged a forward P/E of 22.6 which has continued to increase as its earnings became more resilient, growth became scarce and interest rates continued to fall. So CSL's 24% annualised return has been generated almost 50% by earnings growth and 50% by P/E re-rating.



The key point here is that valuation alone does not lead to a share price pivoting one way or the other. There are several factors involved such as the industry growth, size and opportunity, the potential for the compounding impact of earnings, other opportunities available in the marketplace, liquidity in the system and interest rates. Over the decade CSL has moved from a market multiple to a premium multiple stock and regardless of some weaker EPS growth years, the market now affords it a premium multiple, given the perceived long-term sustainability of its growth.

Relevance to India

If there is a CSL in Australia and A2Milk in New Zealand, then India has not one but several such companies with the potential to compound earnings over the upcoming decades. This occurs because many more industries are growing at a much faster pace given India's fundamentals.

Companies like HDFC Bank, Bajaj Finance (financial services), Britannia Industries, Nestle India (food/consumption), Maruti Suzuki and Eicher Motors (4W and 2W transport) have all produced significant outperformance compared to "investing in India", given they belong in growth industries and are market leaders within those industries. Valuations of these companies started at market levels before their P/E's rose to reflect their compounding nature.

Company	EPS Growth 10 Years p.a.
Bajaj Finance	45%
Eicher Motors	31%
HDFC Bank	23%
Britannia Industries	21%
Maruti Suzuki	12%
Nestle India	10%

An example is a stock like Bajaj Finance which due to its significant compounding earnings over the last decade has moved from a Price to Book of 1x to 9x in 2019. The opportunity in India is to find another Bajaj Finance – a strong business in a nascent market with strong tailwinds and not discovered by the market in 2010. The key being to identify the growth industry of this decade and identify the winner. The same can be said for Eicher Motors.

As can be seen from the table above, all six companies fit within consumption and financials theme which were significantly re-rated upwards in the decade of 2010-2020 due to the sustainability of consumption and credit growth from a low base. Whilst this trend is not over, the market multiple for these industries is now more reflective of their compounding growth opportunity.

Decade	Industry Moving from Market to Compounder	Logic
1990's	Information Technology	Outsourcing became India's growth industry as it used its labour cost arbitrage to reduce costs for businesses worldwide
2000's	Capital Goods, Infrastructure and Engineering	India went through a private investment boom with an increase in capacity and infrastructure
2010's	Consumption and Financials	Balance sheets became constrained and consumption and credit overtook the economy
2020's	Manufacturing / Exporters	India will use its technical expertise, working age population and pivot from China to take up a greater % share of the supply chain

It is our view **that every decade/cycle there will be compounding opportunities thrown forward given India's fundamentals.** These may be in sectors like Pharmaceuticals, Engineering, and Information Technology/Communications. Ideally participation from market pricing to premium valuations whilst the company is encountering structural growth at a more rapid pace, provides strong compounding returns.

A Grassroots approach identifies India's future compounders

There are many Indian companies that are currently beneficiaries of the India growth story and are attracting a lot of attention from global investors. Whilst many will continue to thrive in the Indian ecosystem, the future winners will be identified by local grassroots insights that go beyond simple quantitative metrics. Great opportunities are not found in a simple screen or low P/E. They are difficult to find, to comprehend and to value. Our grassroot advantage allows them to:

- Correctly distinguish junk from quality and not getting into value traps
- Information that is readily available provides little insight. They spend the time, effort, and money to figure out a business's strengths to generate FCF and compound earnings
- They understand the nuances of Indian corporates and management/founders.
- Identify companies that have Darwinian advantages (unlike competitive advantages that are short lived) which not only focus on barriers to entry and but also barriers to success
- Identify management who allocate capital well across the cycle thus performing well in good times and ironically even better in bad times, winning market share from consolidation
- Which companies hold intangible know how which is hard to decipher or reverse engineer. This yields a comparative advantage for a long time and a higher valuation is often justified

Conclusion

Investing in a regional investment like an Indian Equity fund is beneficial to Australian and New Zealand investment portfolio's given the exposure to the fundamentals driving the region which are unique and distinct to other regions. However, most importantly, there are several companies which can provide superior compounding.

We would advise you not to focus on timing your entry, but instead consider it a portfolio construction piece, which you can build a structural long-term allocation to. Building a 3-5% allocation (which is what most clients consider for regional investments) does not have to be done in one go where fear of missing out (FOMO) has played a role. This may be done by dollar cost averaging over 1-3 years to build a position and leveraging off a firm like India Avenue for insights and knowledge.

Psychology and experience tell us that when markets are falling rapidly, investors shy from allocating capital and focus on their core investments (which are witnessing the most impact at the portfolio level). Investors are not going to allocate to regional investments at this point – even though it is often the best time to do so.

In fact, investors are far more likely to allocate all their capital as market peaks approach. Most of their core investments have done well and they are feeling confident about their peripheral investments and are probably witnessing some rapid rises, giving them FOMO. Thus, they allocate to regional investments to squeeze out further growth, having saturated their core allocations.

Structural long-term investments require structural long-term allocations – rather than a focus on getting the timing right. Regional investing is for long-term investors who seek to build a long-term portfolio which will match their long-term need for growth. It is our view that an allocation to India can play a role in Australian and New Zealand investor portfolios.

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