Why India Equities for Global Portfolios

Source: www.emintelligence.com

………and how to play it?

Source: www.blueoceanglobalwealth.com

Strategic Long-Term & Active

Why Indian Equities for Global Portfolios

Introduction

In this report we seek to provide some evidence to global equity portfolio investors on why inclusion of an allocation to Indian equities in a global equity portfolio makes sense on a fundamental basis. We aim to do this through a series of 10 compelling charts and tables.

- Chart 1 – India's Compelling Fundamentals
- Chart 2 – India's GDP Progress
- Chart 3 – The Evolution of India's Economy
- Table 4 – India's Industries of Influence
- Chart 5 – The Association of GDP and Market Cap
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Why are we persistent on the portfolio inclusion of India? Market behaviour tends to see investors exhibiting reactionary behaviour to change and evolution. Today investors are loading up on China in their portfolios post confirmation of its growth over the last two decades and greater weight in the MSCI ACWI / EM. India is likely to undergo something similar when fundamentals are compared, yet many investors remain underinvested (estimate a 0.5% weight in most Balanced Funds) relative to the country's economic weight.

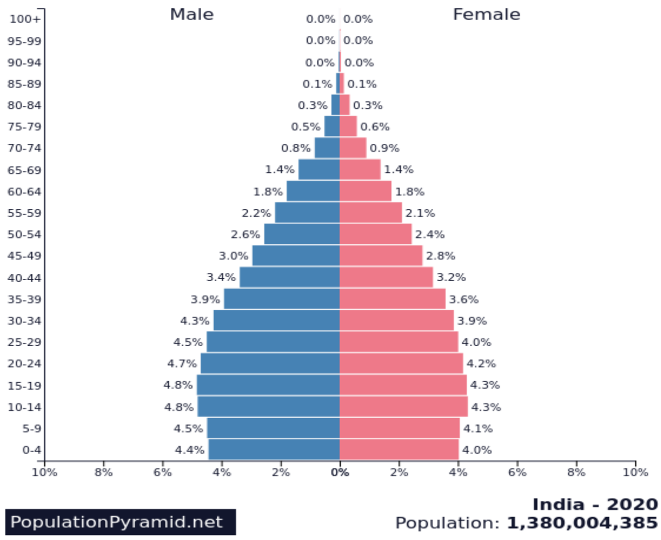
Our View

It is our view that investors should consider front running the MSCI ACWI by raising the strategic long-term weighting to markets like China and India ahead of time. We advocate this by either of the following methods:

1) For those who have a "bucket" for EM/Asia allocations, we advocate one EM/Asia focused manager, supplemented by exposure to an actively managed China fund and actively managed India fund. The EM/Asia manager can provide some exposure tactically to China and India (most likely comprised of the top 5-10 stocks in each country), which is supplemented by deeper exposure in both these deep markets which play several local thematics and provide the diversity of the local fundamentals.

2) For those who only have an aggregated Global Equity bucket, we advocate ACWI based managers be complemented with an actively managed China fund and an actively managed India fund. The Global Equity managers should be able to access the best large and liquid companies around the world including those at the top of the market cap pool in China and India like Tencent, Alibaba, Reliance Industries and HDFC Bank. They will be tactical in their approach to India and China and measure the opportunities against what else is available globally. However, a strategic long-term allocation to China and India will mean investors remain invested in these markets, playing localised fundamentals in a more direct manner.

India's Compelling Fundamentals



India's significant, youthful and entrepreneurial population provides significant fundamental tailwinds over the next few decades. The population is approaching 1.4 billion, equivalent to 17.7% of the world.

India's population is currently growing at about 1% per annum. The median age of the population is currently 28.4 years and forecast to rise to 38.4 by 2050. Comparatively, Australia, China and the USA have an average age of 38 years respectively.

The dependency ratio (number of dependents below 15 and above 65, divided by the population between 15-64) of India has fallen from 80% in 1963 to approximately 48%, ranking it 58th in the world. Australia ranks 82nd with a ratio of 53%. Regions with low dependency ratios (all below 40% except China and Thailand slightly above) include:

- Middle East (Qatar, Kuwait, UAE, Bahrain, Saudi Arabia)
- Asia (Singapore, Korea, Hong Kong, Macao, China and Thailand)

As India shifts increasingly from a young population to a working age population, its GDP per capita will rise as experienced by China from 1980-2010 (which bottomed out at a dependency rate of 34%). This transition will occur from 2020-2050 before passing the reins to Africa beyond 2050.

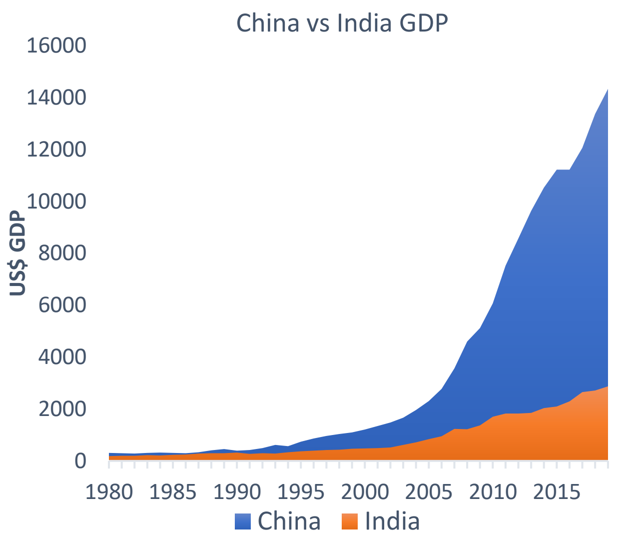
The population density of India is 460 people per square kilometre. Two cities are above 10 million in size (Mumbai and Delhi), but a further 28 have a population above 1 million. Life expectancy has increased significantly from 38 years for a male in 1950 to 70 years in 2020. Infant mortality has also improved dramatically from 275 per 1000 births in 1950 to 27.

Massive urbanisation awaits ahead. India's rural population has gone from 85% in 1950 to 65% by 2020. It is likely that India's rural and urban population be split 50/50 by the year 2050, meaning that 400m people are likely to urbanise over 2020-2050.

Significant wealth gains await as nominal GDP growth outpaces population growth by quite a margin going forward. Additionally, as livelihoods continue to improve through better education, healthcare, medicine, sanitation, drinking water access and services, the productivity of the nation will result in rising GDP per capita. India's significant growth in the last decade has substantially reduced India's population below the poverty line (by nearly 10% in the 2010's)[1].

[1] Poverty and Equity Brief, World Bank, January 2020

India’s GDP Path



China and India had a similar GDP as recently as 1987. However, from 1990 onwards China took giant leaps driven by manufacturing (with the benefit of low labour costs) and a more directive political system. The compounding effect of this can be seen in the chart.
From 2000 onwards India has starting ascending, with the best to come over the next 30 years. However, India’s growth story will not be driven by necessarily by low-cost labour. It is more likely to be driven by value-added manufacturing and its own need for infrastructure and consumption.

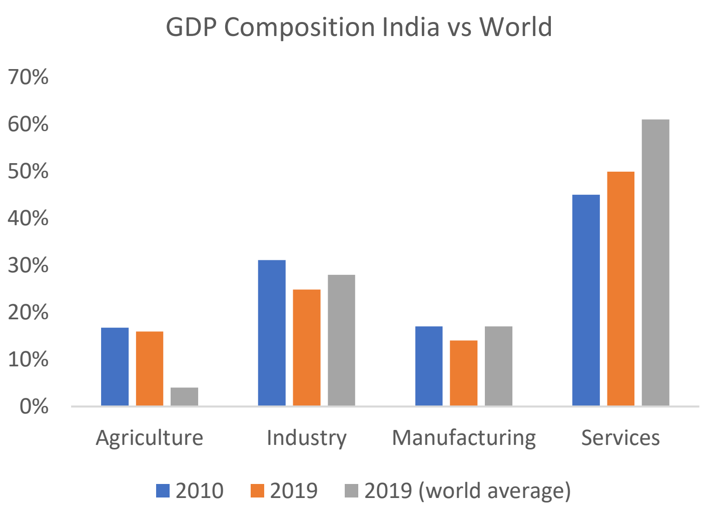
Source: tradingeconomics.com

The Indian Government set a GDP target of US$5 trillion, to be achieved by 2024, in a pre-COVID environment. It is more likely, in our view, that this will be achieved in 2026 given the impact of negative growth experienced in 2020, which has delayed India’s progress.

In a perverse way COVID-19 has had a positive awareness impact on the rest of the world’s view on India as well as address the political need to refocus on growth and resilience for its success. This bodes well for the decade ahead. On the back of reforms, India’s productivity and efficiency should accelerate and benefit significantly from technology advancements concurrently.

It is likely that India will ascend at some point over the next 30 years to be the world’s 3rd largest economy, behind the USA and China.

The Evolution of India’s Economy



India’s economy has emerged from an agrarian background (50% of GDP in 1950) to a services-driven economy. However, agriculture is more important to India relative to its importance globally (average of 4% of GDP). The focus of the Indian Government going forward will be to lift India’s manufacturing share (peaked at 18%) which has now dropped to 14% of GDP.

Source: India Avenue Research

China benefitted significantly given they undertook a drive towards manufacturing in conjunction with a dropping dependency ratio. This was highly accretive to China's GDP at the expense of manufacturing in more expensive locations.

India's economy shifted directly from being agriculture/rural focused towards an urban shift to pursue services related activity rather than manufacturing. Cities like Mumbai and Delhi witnessed a shift by migrant labourers from rurally based regions to generate better livelihoods.

India's industries of excellence over history were textiles, precious gems, refined petroleum and IT outsourcing (from the mid 90's) in terms of exports. More recently automobiles and components, electronics and components, chemicals and fertilisers and generic drugs have emerged as significant value-added export industries.

Over the next decade India will have to pursue a greater emphasis on manufacturing and exports to drive job creation and wealth gains. The tailwinds of pursuit of diversity of global supply chains will lead to increasing attention towards foreign and local private investment capital (reversing the trend of public "crowding-out" and related bureaucratic inefficiency) and the economic development of India.

Economic Reform Journey

Reform / Initiative	Action Taken	Impact
Aadhaar Card	1.2bn people biometrically identified	Identity, audit, efficiency, trace and reducing slippages
Jan Dhan Yojana	400m bank accounts opened	Financialisation to link with national ID, mobile phones
Insolvency & Bankruptcy Act	Clean up of bad debts within the financial system	Rules for lender recourse, resolution process and confidence in the financial system
Demonetisation	Cleansing "black money" by withdrawing currency from the system	A shift to financialisation and digital payments, with an audit trail
GST	Introduction of national tax	Increasing tax revenues over time, less complexity. Reducing the impact and dispersion of state duties and taxes
Corporate Tax Cut	Cutting corporate taxes from 30% to 22%	Globally competitive tax rates with other manufacturing locations
Labour Reform	Setting a standardised labour code	Transformed work environment and basic rights
Agri Reform	Removal of price setting and allowing market price determination for farmers	Increase private investment in agriculture and increased productivity
Make in India	Promotion of India's manufacturing capabilities	Greater importance in the global supply chain. Place to do business
Smart Cities	Expansion of Wi-fi enabled cities along major routes	Improving urbanisation and physical and digital infrastructure
Digital India	Improve India's digital infrastructure via smart phones, national ID, internet	Improve the connectivity of India and enhance business and inclusion
Skills India	Training 400m people in different job skills	Create job opportunities for youth to capture the "dividend"
Swaach Bharat	Clean up via access to services and infrastructure	Improvement of livelihoods at lower socio-economic groups and increased productivity.

India’s Industries of Influence[2]

- **Agriculture** is the primary livelihood for 58% of the population, with Forestry, Fishing, Crops and Dairy being significant globally (US$39bn, growing at 15% p.a.). Leading producer and consumer of **Dairy** products since 1998. Milk share globally is 19%. Consumes almost all the domestic produce domestically (dairy growth is 16% p.a.).
- World’s 4th largest **Automobile** market, increasing at 8.3% p.a. Exports are currently growing at 14.5% p.a. India likely to be world’s leading 4W/2W producer this decade.
- **Biotech** is 12th in the world at over US$65bn. Growth, health consciousness, population and pool of scientists makes India ideal for growth in this industry.
- Second largest **Cement** producer in the world accounting for 8% of global capacity (approximately 350m tonnes expected to grow to 600m tonnes by 2025).
- **Gems & Jewellery** contribute 7% of GDP and is 15% of exports. It is a significant employer and player in cut and polished diamonds. Market share is 29% of global consumption.
- **Electronics manufacturing** in India accounts for 2.5% of GDP and hires 13m workers. India’s digital economy could growth to US$1trillion by 2025. Also seeking to product 1bn mobile handsets by 2025 and currently is the 2nd largest manufacturer of smart phones. The industry is growing at 13% p.a. and is expected to be the 5th largest in the world by 2025 at approximately US$400bn.
- Second largest consumer of **Fertilisers** in the world. Crop yields are increasing significantly through technological advances in fertilisers and usage which is growing at 13% p.a. Market size US$100bn.
- **Info Tech** sector likely to double by 2025. Over 1000 global delivery centres across 80 countries have been set up by Indian firms. Emerging global digital hub with 75% of global digital talent. Market growing at 6% and to approach US$350bn by 2025.
- India is home to Asia’s second largest **Refiner** in the world. Largest contributor to oil consumption globally. Energy demand expected to double by 2035. Capacity is 250m tonnes.
- **Paint** industry is the 2nd largest globally, growing at 9% p.a. Decorative paint is 75% of local industry, benefitting from rising income, urbanisation, development, monsoon, infrastructure.
- Largest producer of **Generic Drugs** globally. Supplies over 50% of global demand for vaccines and 40% of generic demand. The **Pharmaceutical** sector is expected to grow to US$100bn and medical device market to US$25bn by 2025.
- 3rd largest producer of **Electricity** globally. Ranked 4th in wind power, 5th in solar power and renewable power installed capacity. 6th globally in making clean energy investments.
- The **Retail** industry is above US$1trillion and growing at 12% p.a. and is the 5th largest globally. Accounts for 10% of GDP and 8% of employment. E-commerce is growing at 30% p.a. Organised retail is growing substantially from less than 10% in 2017.
- Second largest producer of **Crude Steel** producing 111 metric tonnes. Steel consumption is growing at 7.5% p.a. Production is expected to grow to 300MT by 2030. The per capita consumption of steel has increased from 58kg to 74kg over the last 5 years.
- Significant importer of Metallurgical Coal used to make steel. 25% of Australian exports (surpassing China). 3rd largest importer of Australia’s Thermal Coal (used for electricity).
- World’s largest data usage per smartphone at an average of 10GB per month and expected to double to 20GB over the next 5 years. Second largest **Telecommunications** market with a subscriber base of 1.2bn. Internet subscribers of 700m, growing at 45% p.a. in the past decade.

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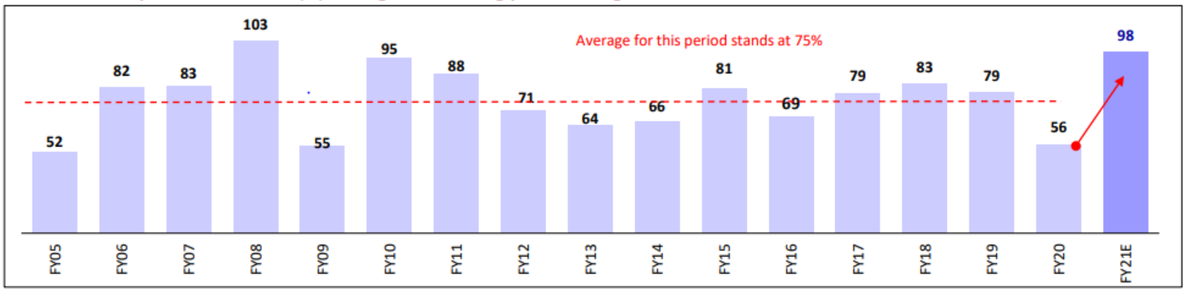
[2] **Source: indianmirror.com/indian-industries/2020**

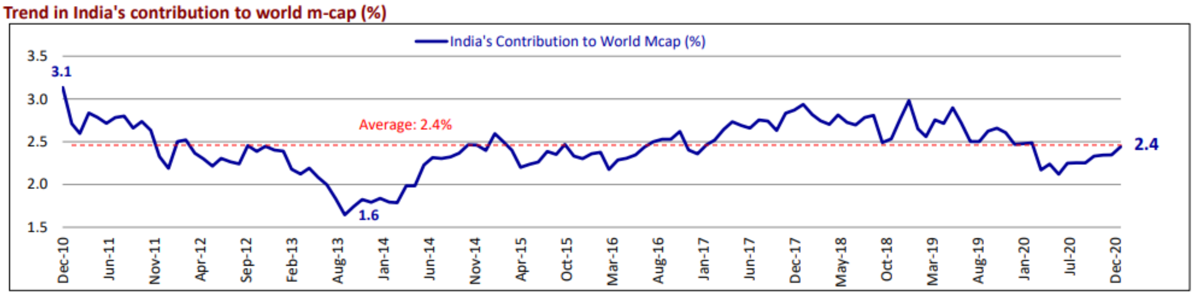
- The **Textiles** industry is 7% of global industry output by value. It contributes 2% to GDP and employs 45m people. Textiles is 15% of India's exports and expected to be US$75bn by 2022.

The Association of GDP and Market Cap

India's market capitalization-to-GDP (%) trading above its long-period averages



Trend in India's contribution to world m-cap (%)



Source: Motilal Oswal

India's market capitalisation has had a reasonable relationship to its GDP. The range of market-cap-to-GDP has been between 0.55 to 1.03 over the last 15 years. India is one of the top 10 markets by size globally, currently at US$2.5 trillion. India's contribution to world market capitalisation is likely to increase from here, given strong GDP growth and India's burgeoning IPO ecosystem, likely to occur over this decade.

Based on our expectation of a nominal GDP of US$5trillion by 2026, it can be expected that India's market cap can double over the next 5 years, increasing its share of global market capitalisation.

Markets, Companies, Regulation and Governance

India's markets have continued to grow in its size over time. Given its entrepreneurial and aspirational population, it also has the greatest number of listed companies domiciled locally at over 6,000. Whilst only the top 1000 of these are liquid and investable, the large number of companies is reflective of the contribution of India's significant and entrepreneurial MSME sector (30% of GDP).

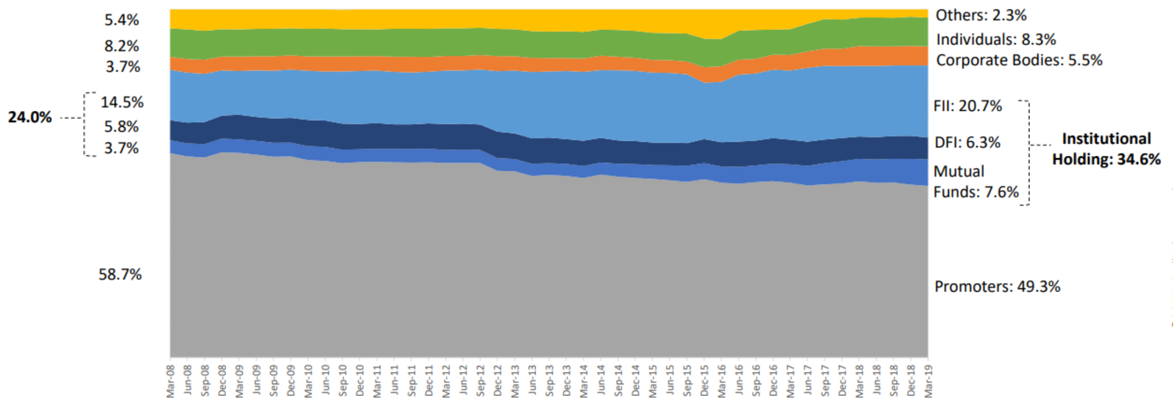
Over the next decade significant privatisation of Government owned assets is expected to increase efficiency and to provide funding for the deficit. Additionally, given GDP growth expected and emerging industries (particularly internet unicorns), it is likely that IPO's will be substantial as opportunities arise for entrepreneurs to list and gain access to capital markets.

India has two stock market exchanges – the BSE (1875) and NSE (1992). The BSE has 5500 plus listed firms. However, the top 500 form 90% of market cap. The NSE (1800 plus listings) is more liquid and has higher trading volumes.

Both markets are order-driven which brings increasing transparency by displaying all buys and sells in the trading system. Buyers and sellers remain completely anonymous. Equity markets follow a T+2 rolling settlement. Each market has its own clearing house that assumes all settlement risk by serving as the central counterparty. The overall responsibility of development, regulation, and supervision of the stock market rests with the Securities and Exchange Board of India (SEBI), which was formed in 1992 as an independent authority.

India started permitting outside investments only in the 1990s. Foreign investments are classified into two categories: foreign direct investment (FDI) and foreign portfolio investment (FPI). All investments in which an investor takes part in the day-to-day management and operations of the company are treated as FDI, whereas investments in shares without any control over management and operations are treated as FPI.

Foreign entities and individuals can gain exposure to Indian stocks through institutional investors. Many India-focused mutual funds are becoming popular among retail investors. Investments could also be made through some of the offshore instruments, like participatory notes (PNs), American or Global depositary receipts (ADRs/GDR's), exchange-traded funds (ETFs), and exchange-traded notes (ETNs). Institutional investment in India has been increasing significantly over the last decade.



Source: IiAS India

Governance

India ranks 13th in the world for protecting minority shareholders (World Bank). Significant attention has been given to aligning governance to G20/OECD principles. Other unique regulations to India include:

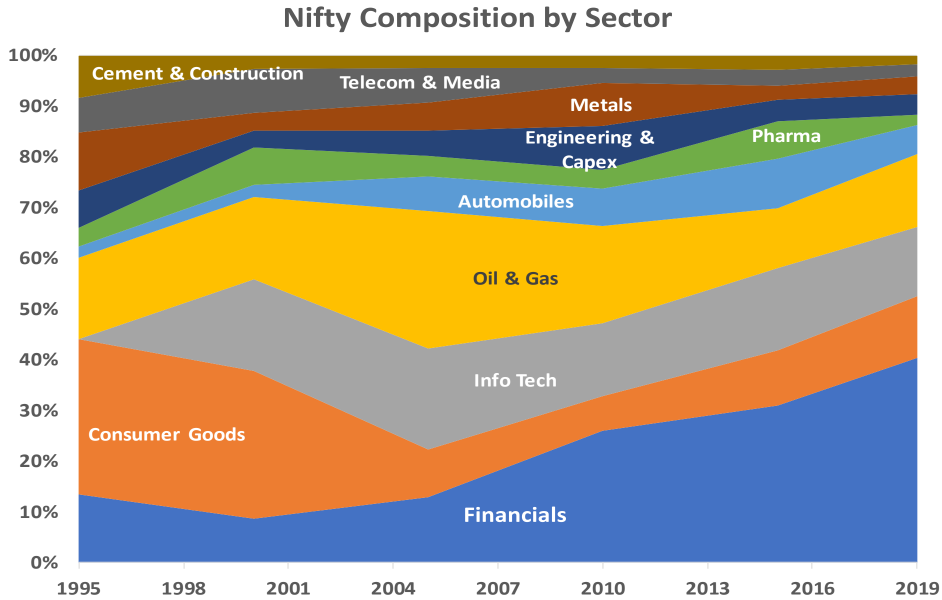
Subject	Regulation
Board Evaluation	Review conducted every year and methodology to be disclosed
Auditor Rotation	Maximum of two five-year terms. Audit partner rotation. No other services
CSR	At least 2% of profits of the past three years to be spent on CSR
Women Directors	At least one female director
Dividend Policy	Top 500 must disclose their dividend policy

A committee called the Kotak Committee was recently put in place to monitor Board Effectiveness, Monitor Group Transactions and Entities, Disclosures and Transparency, Audit Quality and Investor Participation.

Companies with better governance outcomes are experiencing a premium in their valuations relative to their peers. Additionally, corporate industry disclosure (include ESG reporting) and governance levels are improving year by year.

Composition and Change in Indian Equity Markets

India's equity markets continue to evolve with change and response to the global environment as well from evolution in the local ecosystem. 25 years ago, India was driven by Consumer Goods and Commodities. However, over time, increasing financialisation and IT outsourcing have led to the development of major industries.



Source: Motilal Oswal, India Avenue Research

Going forward, industries like Automobiles, Pharmaceuticals, Info Tech, Communications and Engineering and Capex are likely to see increases in weighting due to a shift towards manufacturing, increasing digitalisation and technology driven investment.

<u>In an evolving environment like India's, it is our view that active management can play a significant role in investment returns</u>. Indices are also becoming increasingly polarised and concentrated in investments, leading to poorly diversified portfolios. Further, companies like Divis Laboratories are new entrants to the Nifty 50 in 2020, whilst several Government owned Utilities are exiting given the shift in profitability base. Active management managed by local investment teams have a proven track record of being able to be ahead of the curve.

Implementing a Positive View on India

The history of India's market behaviour shows that market returns can be volatile given linkages to global factors as well as local factors. Quite often geo-politics, local investment cycles, reforms and regulations can create greater dispersion due to lesser liquidity to absorb capital flows (although this is improving due to greater and more regular local investments via monthly investment plans).

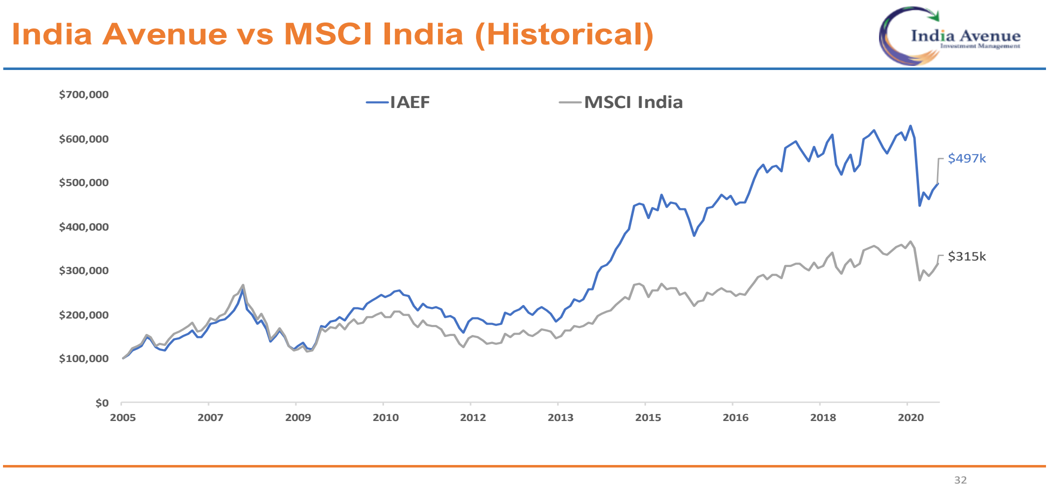
For longer-term investors, this volatility has less significance as India is likely to produce strong annualised returns due to the fundamental tailwinds in place to drive corporate earnings growth. India has seen significant returns in years like 1995-1999, 2003-2007, 2009, 2013-2017. However, tactical investors frequently fail to achieve the same results, often investing after significant positive return periods.

Unlike many developed market participants, in Indian equities, active managers have thrived during positive environment's experience by the economy. Most active managers in India are focused on identifying successful growth companies which have some or all the following characteristics:

- A protective moat which enables longevity of success
- A growth market or industry which the firm operates within
- A strong and recognisable brand or distribution capability
- Market leadership potential
- Positive reform and political thrust

Foreign investors do not come to India seeking companies primarily offering a valuation buffer or utility like dividend payers. Rather they seek companies for the growth they offer through the country's appealing fundamentals. Local investors also have typically sought capital gains rather than yield, as fixed income yields are quite attractive and provide the need for income. The clientele effect of dividend yield vs capital gains favours seeking long-term growth (more attractive taxation).

During periods of economic weakness and falling demand, active managers may be more circumspect in their willingness to take on active risk and instead focus on the IT, Pharma sectors (due to their linkages to exports and foreign currency revenue). However, over the longer term strong active returns have been achieved through the hunt for growth stocks with exposure to local fundamentals that can outperform the market substantially.



When we look at the history of performance of India Avenue's current investment advisers (rebalanced 6-monthly to model weights), then it is noticeable that the result achieved is superior to the Index after fees. This is due to a combination of stock selection by advisers, adviser selection by India Avenue and weighting assigned to each adviser over time. <u>In general, a broader exposure to Indian equity markets has allowed for outperformance of market cap focused indices where knowledge of the local ecosystem in critical to stock selection value add.</u>

Our view is that to achieve the optimal result from a positive long-term strategic view on India, the best method of implementation is via a focused India-only, actively managed fund, with a healthy dose of emerging companies, which benefit from positive economic environments.

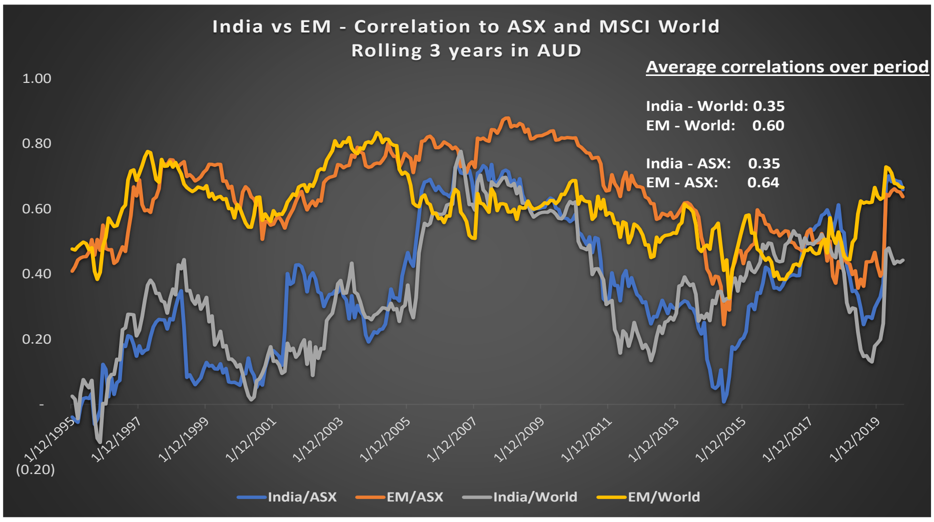
Three themes which we think will drive markets over the next 5 years are:

- Market shares leaders across growth categories will continue to command increasing share as India shifts from unorganised to organised business. Low interest rates and availability of capital will allow these businesses to invest and grow faster.
- India's manufacturing capability will come to the fore as the world seeks diversity from China in the global supply chain. India's importance in certain industries highlighted earlier will grow from this China + 1 view.
- Infrastructure and Urbanisation will drive growth for domestic cyclicals, which are currently undervalued given recent under investment and weak demand.
- India's relevance in the Technology and Communications space will increase substantially given low cost of data, significant digital infrastructure, and large population. With several IPO's in the tech space likely and a focus on greater self-reliance, watch for India's tech weighting in Indices to rise dramatically.

Portfolio Perspective

Whilst the fundamentals of India have always appeared attractive, Australian investors have been reluctant to make a strategic allocation to Indian equities or for that matter any individual country, due to lack of familiarity and knowledge. The preference has been toward allocations to generalists who can be selective across countries in their mandate (generally favouring Global, Emerging Market Funds). However, some clear disadvantages associated with this method of implementation are:

1. Loss of some of the specific diversification benefits of investing strategically in countries like India (with unique fundamentals) being low correlation to Australian Equities and AUD given the country is a commodity importer compared to Australia's status – we advocate an unhedged investment from an overall portfolio contribution perspective.



2. Lack of depth in investment and sourcing of tomorrows emerging growth stories as more than 50% of the allocation of EM and Asia Funds to India is to the Top 10 market cap stocks in the country. There is insignificant exposure to finding India's Google, Amazon or Tesla, but rather a focus on what is large, liquid and significantly researched (broker coverage). It is more than likely that India will produce significant new unicorns in the next few decades.

3. Generalists quite often sell out when the environment looks poor and seek to return once momentum builds given other opportunities in their investment set. This can lead to a poor experience relative to a long-term strategic investors' perspective.

Concluding Remarks

Our analysis shows that exposure to India relative to EM is more value-adding for an Australian investor. This is despite the diversity apparent from allocating to a broader strategy (i.e. Emerging Market Funds) across 25 Emerging Markets. This is because India has a far lower correlation to Australian Equities and AUD when compared to Emerging Market equities and EM currencies (EM currencies have close to a 0.9 correlation to AUD).

If we wrap our heads around this, India offers stronger long-term growth potential, driven by better fundamentals and significantly more diversity relative to EM or Asia allocations. Additionally, most Global managers today are allocating to the Greater China tech opportunity in any case. Tencent, Alibaba, Samsung, Taiwan Semi-Conductors make up close to 20-25% of the EM Index. Is there really a need to double up with a specific allocation to EM? Or does it make more sense to complement global exposure with specific country exposure which will add growth and diversity to the mix?

In summary, India is likely to outperform EM given its fundamentals (over rolling 5-year plus periods) and provide more diversity to investors than EM/Asia (which will be increasingly dominated by China).

Appendix - India by Numbers

		World	US	China	India	Australia	UK	Japan
Smartphones	Mn	3800	260	851	346	17	56	73
Penetration	%	49	79	60	25	69	83	57
Internet Subs	Mn	4929	312	904	755	21	65	117
Penetration	%	63	96	63	55	87	95	91
Population	Bn	7900	324	1427	1366	25	66	127
% of Population	%	100	4	18	17	0.3	0.8	1.6
Average Age	years	31	38	37	28	39	41	47
GDP per cap	US$	11.4	65.3	10.3	2.1	55.1	42.3	40.2
GDP	US$tn	88	21.4	14.3	2.8	1.4	2.8	5.1
Car Production	Mn	92.1	10.9	25.7	4.6	0	1.4	9.7
Steel Production	'000T m		6120	87660	9245	450	702	7264
House Debt-GDP	%		76	59	13	121	88	64

Source: tradingeconomics.com

India has significant opportunity in terms of growth in smartphone penetration and local manufacturing of phones and components. Internet penetration is also rising rapidly enabling India's digital infrastructure.

The demographics also remain highly favourable relative to the rest of the world. With population growth at 1% and falling, GDP per capita should rise rapidly like China's ratio did given increased productivity, particularly through reform and efficiencies. India is already significant globally in many industries such as Steel, Cars, Pharmaceuticals etc.

Household Debt to GDP remains exceptionally low. India has always had a high savings rate, with bank credit growth only starting to take off over the last decade. There is a long point to go before saturation.

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