India Avenue
Investment Management

WHY INDIA IS A ROBUST ALPHA MARKET

Published by: India Avenue Investment Management

SYNOPSIS

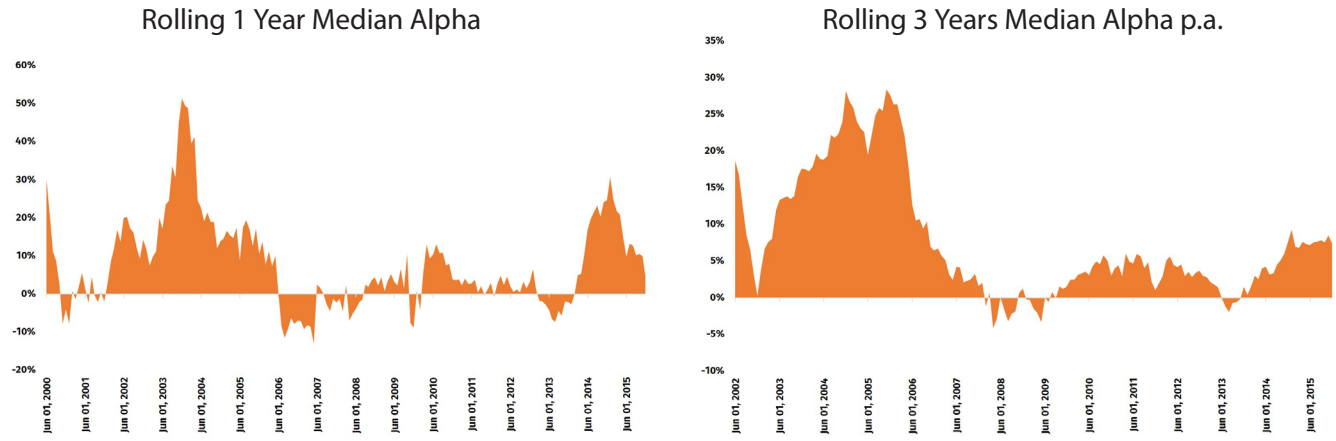
History tells us that mutual fund managers domiciled locally in India have been able to generate sustainably strong alpha over their respective benchmark. In this paper we consider the structural reasoning behind this and if it can be implied sustainably in the future.

Whilst our assessment of alpha generation is built on rolling three year periods, we have also studied shorter term periods, where specific factors may have had an impact. By studying short-term factors and their impacts we can improve our understanding of the drivers of alpha in the future. Whilst we expect our local investment advisers to add substantial value through their stock picking skills over the long-term, our portfolio construction and overlay can add substantially through less volatile alpha achievement over time by understanding short-term impacts.

HISTORY OF ALPHA ACHIEVEMENT IN INDIA

The graphs below highlight the alpha achievement of India's locally based mutual fund managers[1]. It illustrates that alpha achievement over both 1 and 3 year periods have been strong over time.

Chart 1: Rolling Median Alpha – Over 1 and 3 years



Source: MSCI, Ace India MF

Our rolling period graphs indicate that alpha has been relatively robust and sustainable. The average 3 year annualised alpha has been 7.7%. However, this was driven by a very successful period from 2002-2006. In this bull market phase, managers were able to ride on the coattails of mid and small cap stocks which were leveraged to the improving economy.

If we exclude this period, the last nine years have seen an average alpha achievement of 3.0%, which is still significant relative to the achievement of global equity or emerging market strategies. Additionally, it is important to note that these statistics are for a median manager rather than a top quartile manager. With some element of skill in manager selection, the annualised alpha potential is likely to compound at an even greater rate.

In this paper, we seek to assess the key drivers of strong alpha generation over time. These are somewhat structural and related to the market environment, the talented investment pool and significant local network and connectivity which affords depth in scouring through the appropriate companies listed in India.

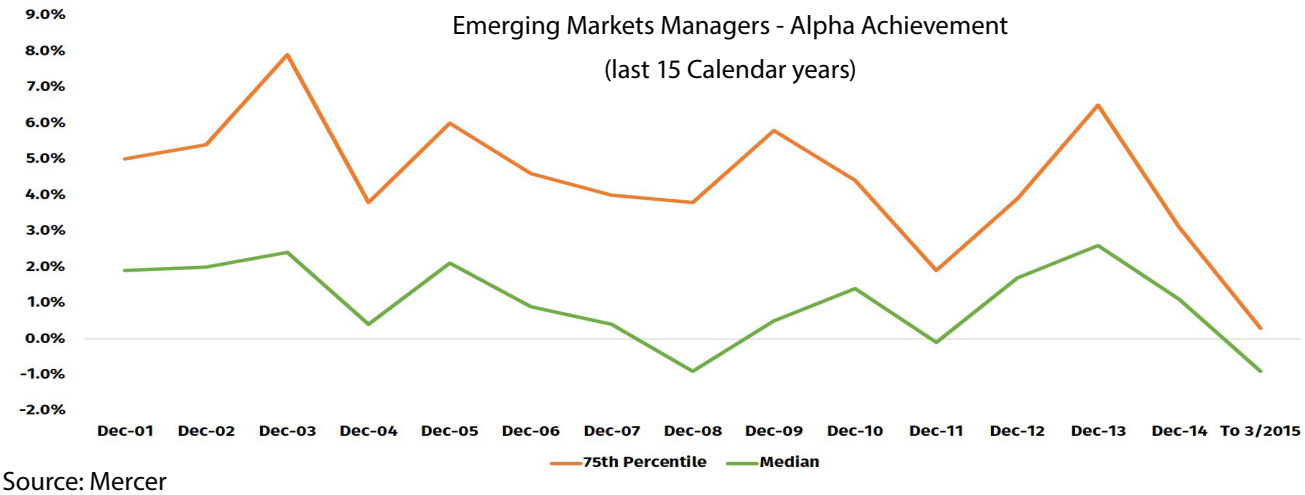
We also seek to understand the drivers of shorter-term periods of strength and weakness. If these are somewhat predictable or repetitive then our portfolio construction and overlay can improve the experience for our investors.

[1] *Our assessment is on multi-cap mutual funds in India which is equivalent to a broad based or diversified equity fund.*

HOW DOES THIS COMPARE TO EM FUNDS?

When comparing the alpha achievement of Emerging Market or Global Equity managers, the alpha achievement of single country and/or regional investments managers is likely to be superior.

Chart 2: Emerging Market Managers Alpha



Source: Mercer

For example our analysis of Emerging Market managers over a similar period indicates that median manager alpha has averaged approximately 0.9% (75th percentile has averaged 4.3%). It is our view that Global and EM Funds tend to generate less alpha as they are more benchmark focused and thereby guided by tracking error constraints or business risk issues. Their opportunity set also tends to reside in the top 20-50 stocks in each market for liquidity purposes rather than scouring the market for "true exposure" to the local economies[2].

Research also indicates that local managers harvest substantial alpha from bottom-up stock selection, which has not been accessible for top global EM managers. Local managers have a stronger focus on domestically oriented stocks, whereas global managers prefer larger export-driven stocks (often ADRs). Finally, local managers' performance has been superior during market stress[3].

Whilst single country or regional strategies have narrower breadth, they often offer much more depth in stock picking insights. It is our view that investment strategies offered by Global or EM Funds provide greater breadth across countries, but can wash away some of its unique and insightful stock selection ideas which comes from investing with the benefit of depth and knowledge of a particular market's structure, industry dynamics, participants, regulatory and political landscape and financial reporting norms.

Global Funds have the benefit of fairly homogenous market structure and conditions across developed markets. Their focus is on large and liquid companies usually with a global revenue base and diversification across some of their high conviction stock ideas. EM Funds on the other hand are trying to diversify risk by investing across various countries, given their insight into each specific market may not have the same depth as locally based managers. However, it is our opinion that this is more through convenience, cost, scale and resources, rather than the optimal way to extract alpha across these markets, which are often driven by specific localised factors.

[2] *Copley Fund Research, India Avenue Research*

[3] *Oliver Fratzscher, "How have local managers performed across emerging markets" CEO at EM Leaders*

EM Funds typically do not add significant value through country allocation as their mandates, particularly over the last decade, tend not to differ significantly from country capitalisation weighted benchmarks due to currency, political or regulatory risk[4]. Therefore it is worth questioning the traditional diversified approach if the value addition expected from a broader universe is not substantial.

We compare the two approaches in the table below based on our views, experience and perception:

Table 1: Drivers of Value Addition – EM vs Local Country Managers

Drivers of Value Add	Emerging Market Funds	Local Country Specific Funds
Opportunity Set	Breadth and Diversification	Depth and Focus
Liquidity	Large and Liquid stocks	Liquidity is not the main driver for stock selection
Global vs Local	Companies likely to have global revenues and influences	Companies likely to be influenced by local demand factors and dynamics
Conviction	Low conviction stock portfolio as attribution is driven by multiple sources and markets	High conviction portfolio, with stock selection driving value addition
Staff Focus	Most investment staff focused on stock selection	All investment staff focused on stock selection
Active Risk	Tracking error is typically 3-4%	Higher tracking error (5-10%)
Flexibility	Focus on generating EM returns	Deeper understanding of country specific beta allows for more flexible management

Whilst EM Funds enjoy a broader opportunity set, it might be depth rather than breadth which drives alpha achievement from these markets i.e. not necessarily more countries and therefore stocks, but more about understanding local landscapes, government reforms and having insights into the behaviour of promoters/founders of businesses which drives alpha. Given that most investment staff are focused on stock selection, then breadth may spread resources too thinly in the desire for coverage, rather than a focus on depth.

It is also true that market beta can be managed by local managers with greater insight into their own markets dynamics[5], rather than by comparing relative attraction across breadth. In most scenarios usage of cash and/or derivatives may provide the best downside protection.

[4] *Nick Armet, Fidelity Worldwide Investments*

[5] *Oliver Fratzscher, "How have local managers performed across emerging markets" CEO at EM Leaders*

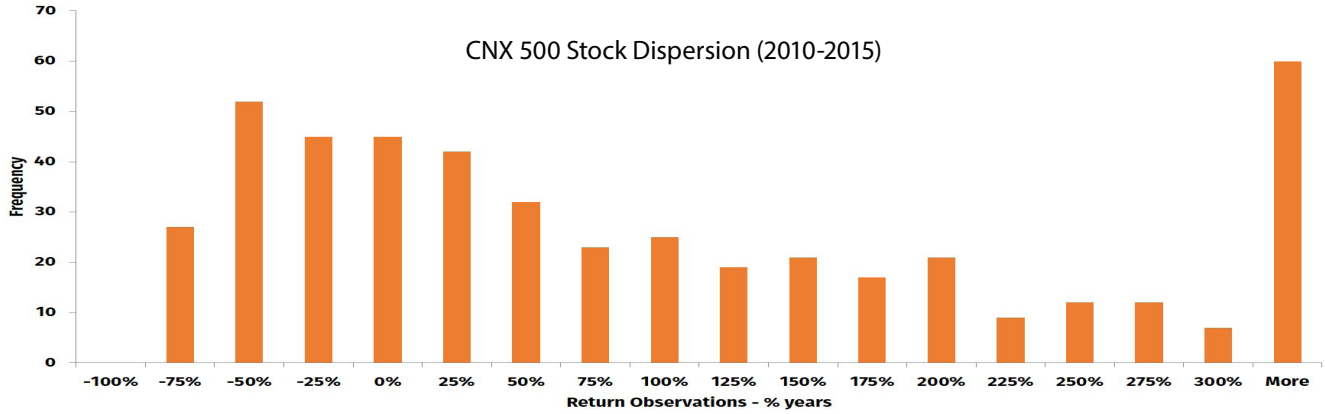
REASON FOR STRONG AND SUSTAINABLE ALPHA IN INDIA

In our view, alpha generation in India and its sustainability is dependent on multiple factors. We list some below and then seek to justify why this may be the case.

INDIA'S STOCK MARKET HAS SIGNIFICANT DISPERSION

India's stock market has around 7000 listed stocks (the largest globally) which provides significant opportunity to identify undiscovered growth stocks through additional insights and market knowledge. Dispersion amongst stocks is also large affording significant opportunities for alpha through diligent and insightful stock picking. The chart below indicates whilst the index itself rose by 36% over the 5 year period, the highest frequency was for stocks which returned over 300%. These names accounted for 12% of the listed companies within the S&P CNX 500 (one of India's broad market benchmarks). The distribution definitely shows "fat-tail" characteristics, which is representative of a highly conducive environment for alpha generation.

Chart 3: CNX 500 Stock Dispersion

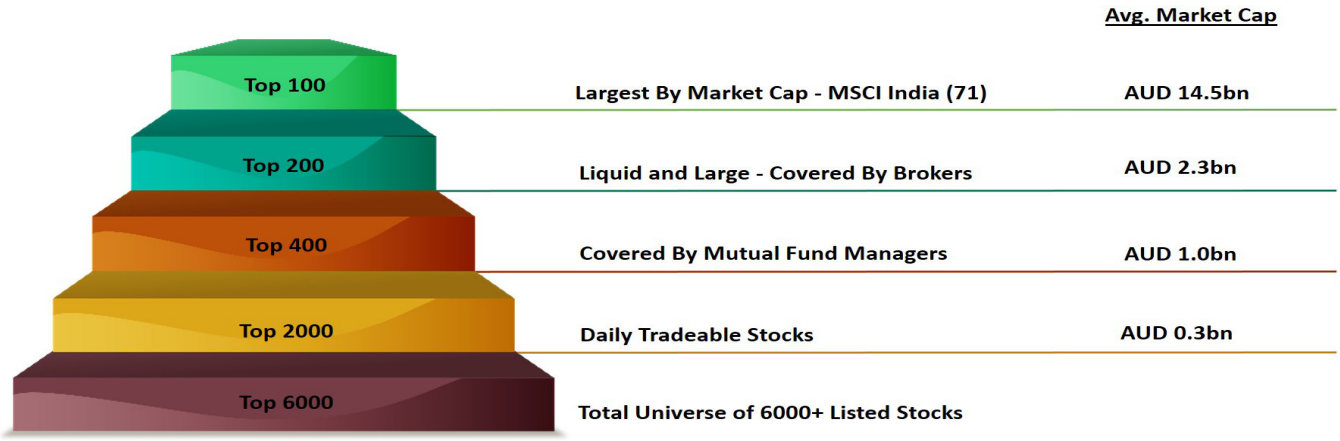


Source: NSE, ACE India

STOCKBROKERS AND GLOBAL MANAGERS ONLY RESEARCH AND INVEST IN THE LARGE AND LIQUID

Global and EM Funds tend to trawl in the large cap stocks due to liquidity[6]. Stockbrokers in servicing these large Fund's tend to focus on the top 150-200 stocks listed in India. However, there are 2,000 stocks which trade daily on the BSE and NSE exchanges, providing significant opportunity for local managers, with a strong knowledge of the reforms, industry trends, promoter relationships and awareness of the IPO pipeline, to add value through their stock selection.

Figure 1: Market Segmentation



SOURCE: INDIA AVENUE RESEARCH, MSCI

LOCAL NETWORK, LOCAL CONNECTIVITY

Being located on the ground in India is a significant advantage in our view, relative to knowledge and insights approaching it from a global lens. Local network and connectivity is established by years of operating within the market. This provides insights, akin to Porters 5 Forces[7], into:

- Promoter/founder behaviour and their track records, which is critical knowledge for investing in Indian markets given that promoters own over 40% of the market cap[8]. Understanding promoter psyche including motivation, character, history and relationships is critical in assessing the virtues of a company;
- Industry rivalry and competition in a marketplace which is experiencing rapid change. Local investment advisers have much better insight into the overall value chain and business cycle of companies. This is achieved through connectivity with the stakeholders, competitors and service providers of a business;
- Local brokers who provide unique thematic research and grass roots surveys. Additionally, brokers are able to identify "Block trades" and underlying parties to get the best and most efficient pricing for trades; and
- Exposure and knowledge of the upcoming IPO pipeline.

[6] Copley Fund Research, India Avenue Research

[7] Porter, M.E. (1980) Competitive Strategy, Free Press, New York, 1980

[8] IIFL Research "Domestic Investors Return to Equities" July 2015

RELIABILITY OF DATA

Within India, reliance purely on statistics and data can be misleading given the size of the population and vastness of the information collation and collection exercise. This creates part of the inefficiency within the market that leads to an opportunity for alpha generation, especially when armed with better insight and access to grassroots information. Local knowledge therefore becomes critical in having a clear vision of a company's market share, potential sources of growth and competitive threats.

LESS INSTITUTIONAL OWNERSHIP LEADS TO MARKET INEFFICIENCY[9]

Institutional ownership of the stock market in India is relatively low at 35% of market cap. Promoters are close to 46% and retail investors hold 19%[10]. The US share market has an institutional ownership level closer to 75%, which is synonymous with higher levels of market efficiency. Institutional investors typically bring a level of sophistication to the market place due to their need for data/information, which tends to increase efficiency within the share market, resulting in stocks converging to fair value much faster.

Global investors have typically adopted a top down approach to India, utilising futures, large and liquid caps and/or currency positioning, rather than pure stock picking. These investors accordingly focus more on macroeconomic fundamentals rather than the micro drivers of change. This creates an opportunity for "arbitrage" and outperformance for locally based investors.

HIGH CONVICTION INVESTING

India's employment system and long-term savings focus is via a provident fund scheme (PF). The structure of this allows employees to remove and utilise their investment balance upon departure from an employer. There it can be viewed more as a nest-egg to utilise for short to medium term goals.

Additionally, PF schemes have had a regulatory ceiling on levels of equity ownership (currently 15%)[11] which has increased from a low level of 5% at their introduction.

Thus the mind-set of retail local investors is built upon the perception that equity investing is for short-term gain rather than long-term wealth accumulation. Equity investments are often compared to liquid fixed income or cash returns rather than equity benchmarks as a hurdle for success.

Mutual Fund managers, in response, have managed money in a benchmark agnostic manner. This has resulted in a higher tracking error, given the need to invest in companies which can produce a higher rate of return than the cash or inflation rate. Active share of investment portfolios is relatively high as investors focus on high conviction in their portfolios and potentially little or no exposure to some index heavyweights which are more mature businesses with greater offshore earnings. Tracking error of Indian Mutual Funds approximates 6-8% per annum[12] and tends to be a fall-out of an investment process rather that a key input to the decision making process.

[9] *Empirical Research Partners, "Active Management: The Existential Question", Portfolio Strategy Jan 2015*

[10] *IIFL Research "Domestic Investors Return to Equities" July 2015*

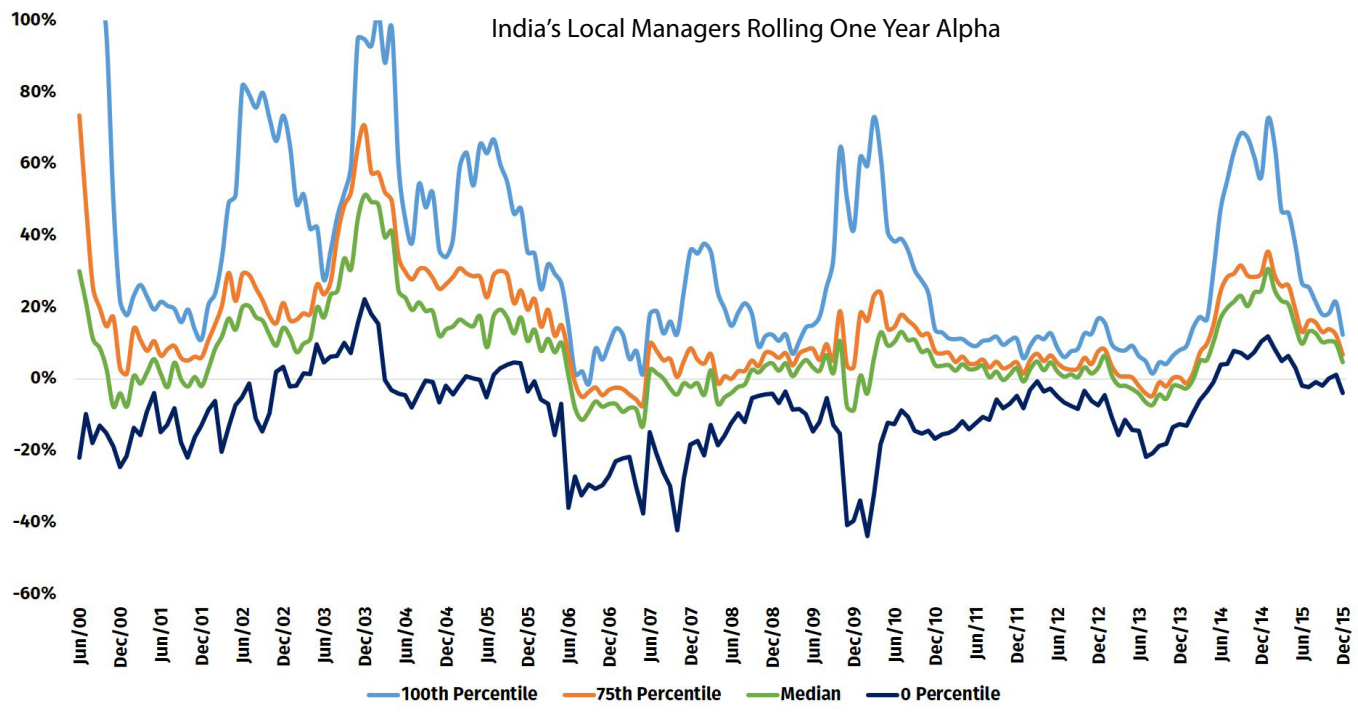
[11] *Finance Ministry*

[12] *India Avenue Research*

PERIODS OF ABNORMAL PERFORMANCE

There are periods of performance where results achieved in the short-term can deviate from long-term trends. These results can be on the upside or downside and we seek to understand when this may occur in an effort to establish some predictability which will then seek to benefit our clients in robust alpha achievement over time.

Chart 4: Rolling 1 year Alpha – Dispersion in Performance

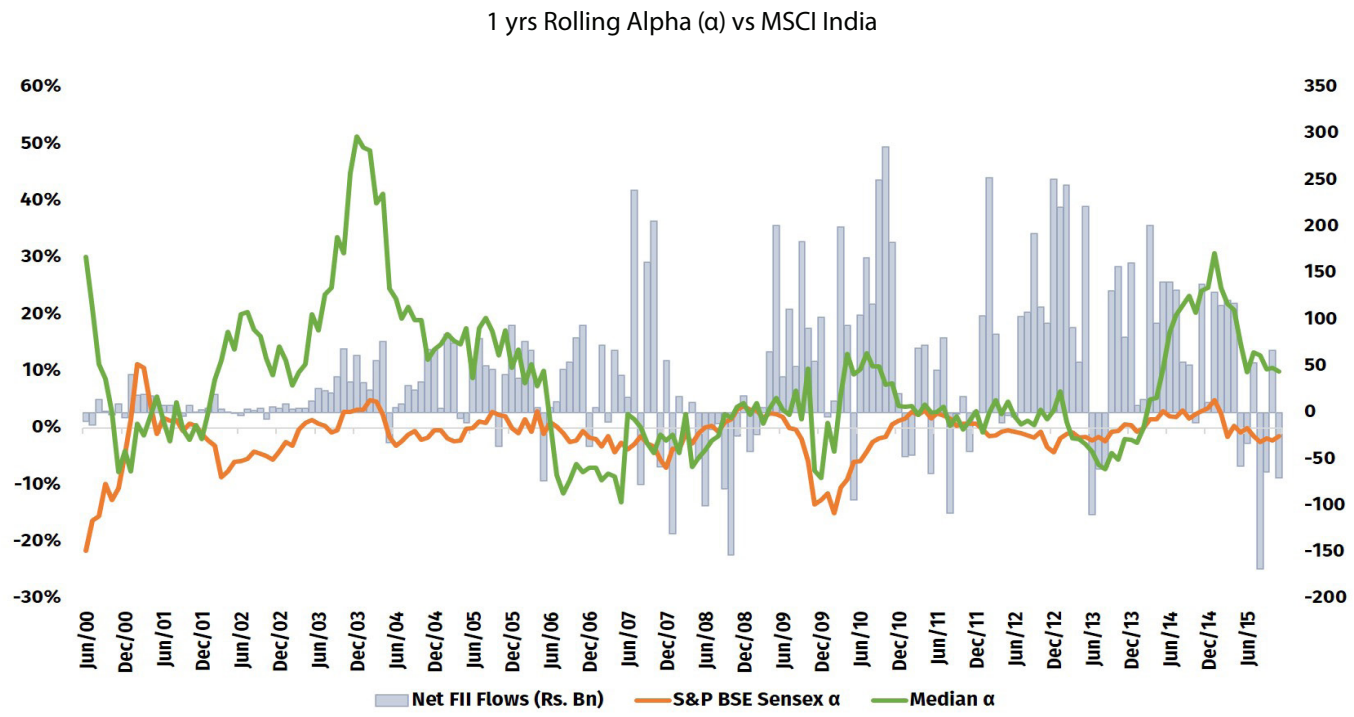


SOURCE: ACE INDIA MF, MSCI

Alpha distribution over rolling 12 month periods (median manager) indicates that value was added 75% of the time and 90% of the time by the 75th percentile manager. Over rolling three year periods the median manager achieved a positive result on 87% of occasions. Some of the causes of a period of abnormal alpha are likely to be:

- Top 30 outperformance (as measured by the Sensex)
- Foreign investor flows
- Market reversal and macro factors

Chart 5: Sensex Outperformance and FII Flows vs Alpha



SOURCE: ACE INDIA, INDIA AVENUE RESEARCH, BSE SENSEX

The chart above indicates the following:

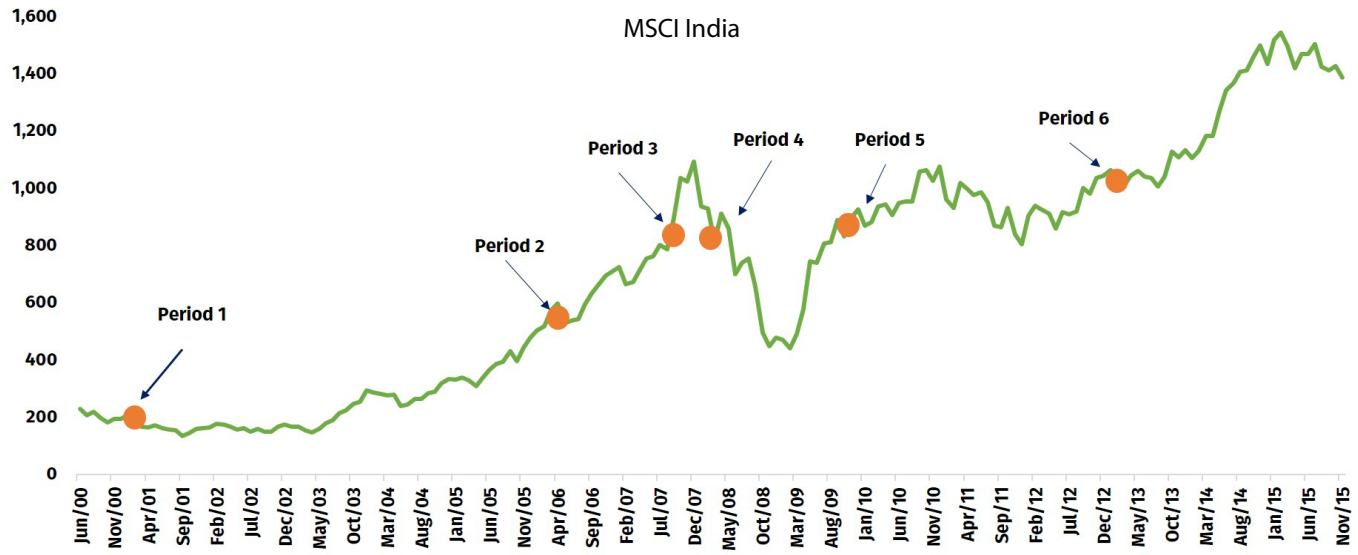
1. The Sensex (Top 30 stocks) has outperformed the MSCI India infrequently (38% of rolling one year periods)

2. Whilst Monthly FII flows have been positive most of the time (74%), manager alpha has only been negative 25% of the time where FII flows were positive. The same weak relationship exists for when manager alpha has been weak.

The outperformance periods by the Sensex has little or no relationship to the outperformance of the median manager relative to the MSCI India. Therefore we can conclude that a liquidity fuelled, large cap rally has not generally been the significant reason for poor alpha. Whilst the relationship between FII flows and manager alpha generation is weak, there is some relationship, particularly during 2H07 when FII flows were intense and the resulting liquidity found its way into risk assets. This flow of liquidity also occurred during Jun12 – Jun-13 as market sentiment towards India started improving.

We test market behaviour and alpha generation against the six periods identified below. These periods have been identified as phases of poor alpha generation.

Chart 6: Performance of the MSCI India where poor alpha is experienced



SOURCE: MSCI INDIA

The periods of negative alpha deliverance, as shown above by the red marks, are described below:

Table 2: Periods of poor performance explained

PERIOD	DATES	REASON
1	Nov'00 to Jan'01 (Alpha of -4.1% to -7.8%)	Reversal immediately post the technology bubble meltdown. Managers holding cash in a short term market spike before weakness continued.
2	Jul'06 to May'07 (Alpha of -6.3% to -13.1%)	A sharp correction of 12% during the month of May'06 due to FII outflows on global weakness and questioning of Mauritius's tax status on Indian investments. The period post this led to a strong liquidity fuelled rally of 10 months where defensively positioned managers underperformed.
3	Sep'07 to Feb'08 (Alpha of -1.2% to -4.5%)	Just as managers had re-positioned due to capitulation on the defensively positioned trade and oriented their portfolios for growth, the sub-prime crisis hit and local inflation rose. This led to a double whammy for alpha effectively from Jul 06-Feb 08.
4	Apr'08 to Aug'08 (Alpha of -1.5% to -7.0%)	
5	Nov'09 to Feb'10 (Alpha of -4.1% to -8.8%)	2009 was a strong period for Indian equities driven by quant easing, fiscal stimulus and local elections in India. However a sudden change of stance by the RBI on inflationary concerns resulted in volatility and poor performance.
6	Mar'13 to Jan'14 (Alpha of -1.8% to -7.1%)	Corruption scandals, policy paralysis, slowing economy and global liquidity concerns had adversely impacted Indian markets. Portfolio managers positioned themselves defensively to protect over this uncertain period. Managers underperformed as markets recovered leading into a favourable election result in 2014.

Each of the above periods have their own circumstances which led to under performance of Indian portfolio managers against their benchmarks

In our view Indian portfolio managers are good at capturing alpha in most market environment. Particularly noticeable is the ability to capture significant value add in a trending market. Value detraction or negative alpha is only likely to occur where there is a sudden change in the market environment or a sudden reversal of an existing trend. This period of poor performance is likely to occur until the time the portfolios are re-aligned to the new environment. Thus it can be inferred that Indian portfolio managers are generally slow to react, especially when the reason for the change in trend results from global events.

It is our philosophical belief at India Avenue that investing in partnership with local investment advisers, by outsourcing stock selection to them, can add significant value. This skill set, when complemented by our own core competencies of portfolio construction and overlay, is likely to soften the impact during periods of alpha weakness. We see our value-add through portfolio construction and overlay to be shaped by some of the following factors:

1. Diversification of investment style across our investment advisers via nimble portfolio construction

2. Identification of periods of momentum/trend behaviour through our analytics, with a view of reducing risks of reversal

3. Use of derivatives not purely to manage beta, but also to reduce the active risk of the portfolio during periods where we determine alpha could be impaired

4. Risk reduction when our advisers exhibit consensus views in the short term

CONCLUSIONS

Local Indian managers domiciled in India have been able to generate strong and sustainable alpha for well over 15 years. It is our view that this is sustainable in the future given the structure of the Indian equity market, the quality of locally based investment managers and the strength of their "grass-roots" network.

We recognise that in the short-term there may be periods of weakness and our experience, global portfolio construction skills and overlay can create an even more robust alpha experience for our clients over various time periods.

Visit: www.IndiaAvenueInvest.com
Write to us at: info@indiaavenueinvest.com