



The case for stand-alone investment in Indian equities

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Marketing material for
professional investors
and advisers only

This paper looks at the structure of the Indian economy and equity market and compares India's performance to other equity markets. It also aims to answer the question – does India merit a stand-alone allocation from global investors, as China increasingly does?

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Introduction

Indian equities have the potential to offer an attractive long-term investment opportunity. The opportunity is backed by the size and the growth potential of the domestic economy, and by recent changes which will remove many of its historic inefficiencies. Local markets are vibrant, with a large set of listed companies across the capitalization range that have a track record of delivering profitable growth and, potentially, diversification benefits to a global portfolio. The depth of the Indian markets means that neither an index exposure nor a limited weighting in an active regional or global mandate captures these growth opportunities fully.

The Indian economy and stockmarket are large and attractive

India is the seventh largest economy in the world. It is also the fastest growing major economy and is expected to remain so. This growth should enable India to become the fifth largest economy in the world within five years (Figure 1).

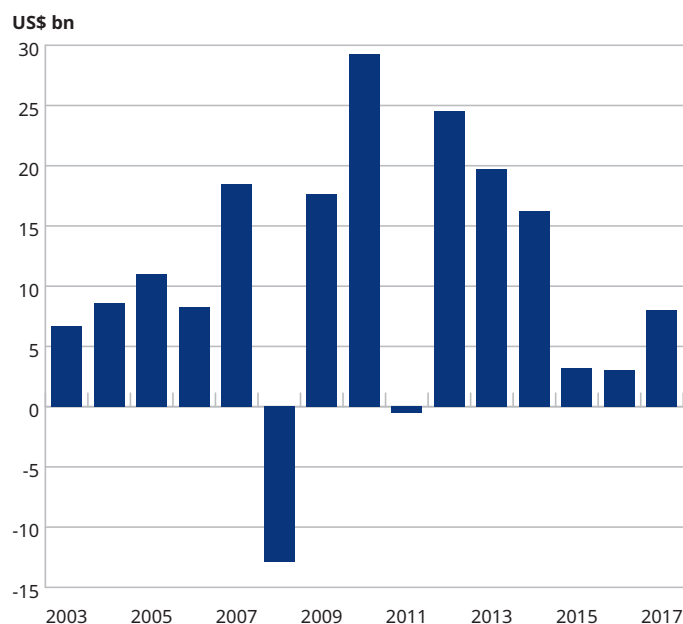
Figure 1: The Indian economy is rising fast in the global league table

(US\$ bn)	GDP 2017 (estimated)	GDP 2022 (estimated)
United States	19,362	23,505
China	11,938	18,383
Japan	4,884	5,482
Germany	3,652	4,452
France	2,575	3,162
United Kingdom	2,565	2,961
India	2,439	3,924
Brazil	2,081	2,629
Italy	1,921	2,244
Canada	1,640	2,052

Source: IMF World Economic Outlook, October 2017

India also benefits from large and relatively open capital markets, allowing foreign investors to participate in a large number of local growth opportunities. This has encouraged global portfolio investors (both multi-country and single-country) to invest sizable amounts in India, as can be seen from Figure 2. It is notable that out of the last 20 years, foreign portfolio investors have been net sellers of India in only two calendar years – one of which was the year of the global financial crisis.

Figure 2: Foreign investors are drawn to India
Foreign portfolio flows into Indian equity



Source: Bloomberg

India is a large and diverse market, with a total market capitalization of over \$2 trillion¹. It is also broad, with a large number of traded stocks. A stratification of stocks by market cap is given in the table in Figure 3. The extensive mid-cap market is a notable feature.

¹ The World Bank, as at the end of 2017.

Figure 3: Breadth is one of the market's attractions

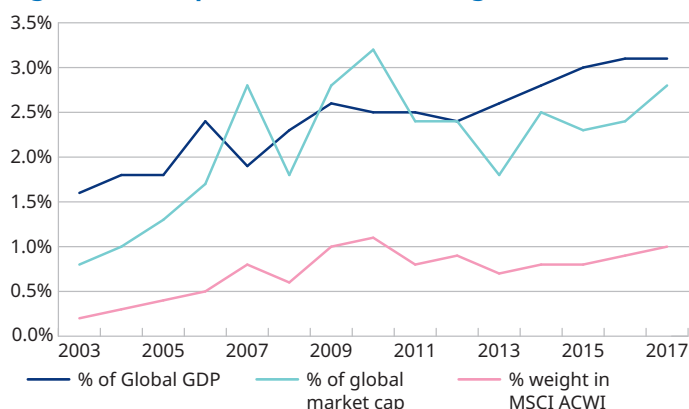
Market cap range	Number of stocks
>\$25 bn	16
\$5-25 bn	72
\$2-5 bn	109
\$1-2 bn	121
\$0.50-1 bn	159
\$0.25-0.50 bn	209

Source Bloomberg, as at 21 February 2018.

India is underrepresented in regional benchmarks

However, despite its strong capital markets and rising economic strength, India has a low weighting in major global/regional benchmarks. Figure 4 shows the recent progression of India's share of global GDP and market capitalisation, alongside its weighting in the MSCI All Country World Index (ACWI). As with China, it is clear that benchmark weights have not kept pace with India's economic growth. The same is true in other broadly tracked regional/global benchmarks.

Figure 4: India punches above its weight in the index



Source: Bloomberg, IMF, Morgan Stanley Research, MSCI and RIMES, as at 14 February 2018.

Some of this underrepresentation is justified, as international investors have been constrained by a combination of low free floats of shares and foreign ownership restrictions in certain sectors. However, this is changing all the time and the benchmark providers have been slow to adapt. India has been lifting foreign investor limits across sectors substantially, as well as getting listed companies to increase their free float.

Furthermore, despite the fact that the domestic market includes a large number of stocks (686 above \$250 million: see Figure 3), only 79 make it into the MSCI India Index. That index focuses on larger, more liquid stocks at the expense of the rich array of small and medium-sized Indian companies. While this problem is not specific to India, it is more of an issue here as the Indian small cap market is relatively large when compared to its large cap market. The MSCI India Small Cap Index is around 25% of the size of the MSCI India Index, or around 10 percentage points higher than small caps are in the broader EM universe or the US market. To access the full opportunity, investors in India have more than the usual need to look beyond the benchmark and consider complementing their existing regional equity allocations with a stand-alone allocation that has the flexibility to allocate across the size spectrum.

Indian equity markets have performed well

Indian equities have given stellar returns over the long term, as local companies have taken advantage of the opportunities provided by a large domestic market and rapid economic growth. The table in Figure 5 provides the risk and return characteristics of Indian equities and other key global and regional benchmarks. We also show the correlation of each market with the MSCI World and MSCI India indices and, in the second table, the performance of the MSCI India Index in the five most recent calendar years.

Figure 5: Indian equity returns have been high, but so has the volatility

Annualised equity returns 2003-2017 in US dollars

	MSCI India	MSCI AC APxJpn	MSCI EM	MSCI ACWI	MSCI World
Total return	14.9%	9.7%	12.7%	9.6%	9.5%
Risk (volatility)	28.5%	16.4%	21.4%	14.8%	14.4%
Correlation with MSCI World	0.7	0.9	0.9	1.0	1.0
Correlation with MSCI India	1.0	0.8	0.8	0.7	0.7

Source: Bloomberg, and Axis AM

Annual total returns in USD

	MSCI India	MSCI AC APxJpn	MSCI EM	MSCI ACWI	MSCI World
2013	-3.8%	3.7%	-2.3%	23.4%	27.4%
2014	23.9%	3.1%	-1.8%	4.7%	5.5%
2015	-6.1%	-9.1%	-14.6%	-1.8%	-0.3%
2016	-1.4%	7.1%	11.6%	8.5%	8.2%
2017	38.8%	37.3%	37.8%	24.6%	23.1%

Calendar year returns. Source: Thomson Datastream.

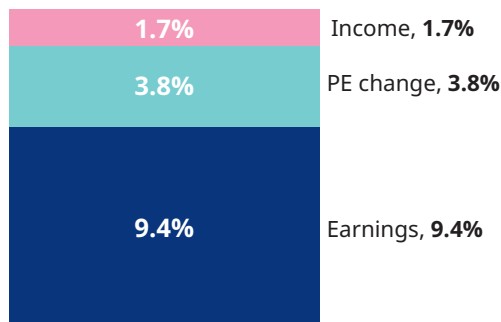
Past performance is not a guide to future performance and may not be repeated.

India has delivered substantially higher returns than broader indices, but with meaningfully higher volatility, over the last 15 years. This level of volatility is not surprising for a single country or market relative to regional benchmarks, and it has been matched by higher return.

Looking at the breakdown of the total returns generated over this period (Figure 6), there are notable differences with other markets. Earnings growth has been the biggest contributor to total returns, and expansion in price-earnings ratios (PEs) has been less significant. It is notable also that dividend yield has formed a small part of the total return. Given the significant investment opportunities on offer and returns on equity well in excess of developed or emerging market averages (Figure 7), companies have preferred to reinvest profits to grow their businesses rather than pay them out to shareholders. Payout ratios have averaged only 25%, well below the 40% to 50% common in developed markets and the 35% in the broader emerging market universe. This demonstrates the more growth-oriented nature of the market, even relative to other emerging markets.

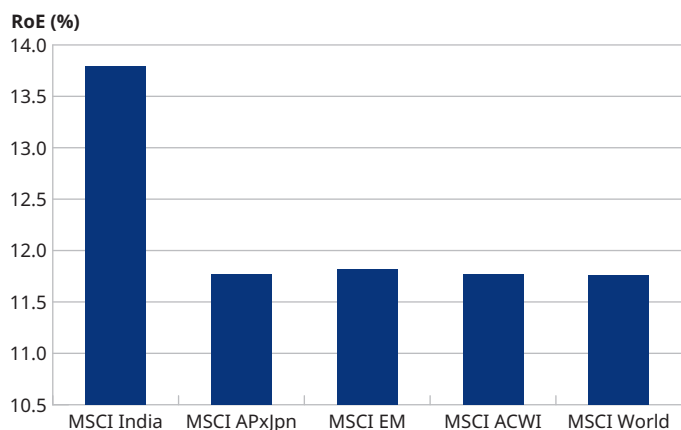
Figure 6: Earnings growth has dominated returns over the past 15 years

Contributors to MSCI India Index annual total return



Data from 2003-2017. Source: Axis AMC analysis and Bloomberg

Figure 7: Indian companies have benefited from reinvesting profits in their businesses



Source: Bloomberg, as at 28 February 2018

Another feature of the Indian market is the large and attractive mid cap sector. Mid caps have handsomely outperformed large caps over the last 15 years, returning an average of 22.2% annually, well ahead of the 14.9% provided by the MSCI India Index¹.

From a diversification standpoint, India has exhibited lower correlations to the MSCI World Index than other Asian markets. The correlation between Indian equities and global equities has been 0.7 over the past 15 years, compared to 0.9 for the broader Asian or emerging markets, and even this masks significant variation over time. As recently as the 2014-15 period, the correlation fell as low as 0.4 (Figure 8). Given the local dynamics, a low correlation should not be surprising, but clearly India is not immune to global developments. Having a greater proportion of mid caps again offers advantages here, as they typically show a lower correlation with global markets. This further emphasises the benefit to investors of adopting a broad approach if they are to reap the full benefits of the Indian opportunity.

Figure 8: Correlations vary over time

Rolling 24-month MSCI India/MSCI ACWI correlation

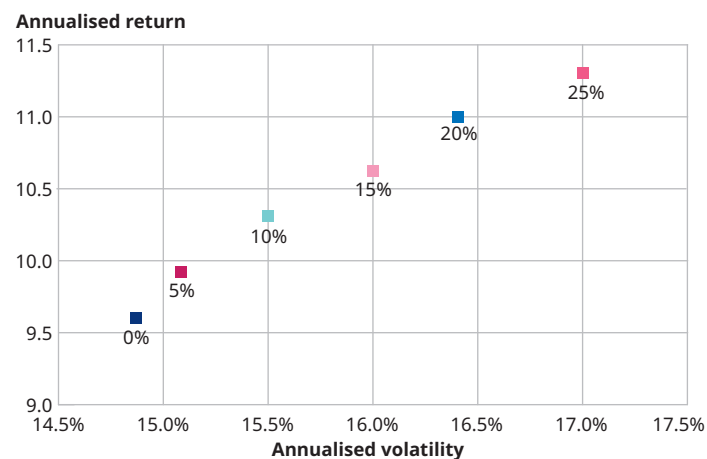


Source: MSCI, Schroders and Thomson Reuters Datastream, as at 31 December 2017

In a portfolio context, adding a stand-alone India allocation to a global equity portfolio would have increased both returns and risk, as shown in the first chart in Figure 9. However, diversification benefits mean that overall portfolio efficiency would have improved (see second chart). And, as previously noted, even this analysis materially understates the potential value of a broader allocation to Indian equities, including mid caps. The combination of higher returns and lower correlations helps in this case, even though investment in India as a single country will always tend to be significantly riskier than multi-country strategies.

Figure 9: Adding India improves efficiency

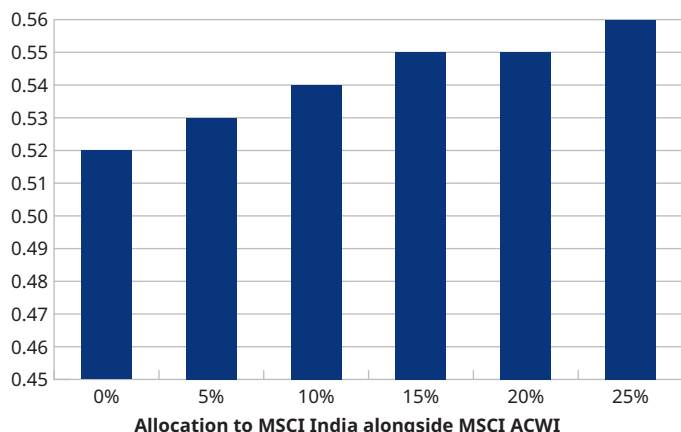
Risk/return plot for MSCI ACWI with different allocations to MSCI India



¹ Mid cap performance measured by Nifty 100 Mid Cap Index; data cover 2003-2017, in dollars. Source: Axis AMC analysis and Thomson Reuters Datastream, as at 31 December 2017.

Risk-adjusted returns would have been improved by adding Indian allocations

Sharpe ratios

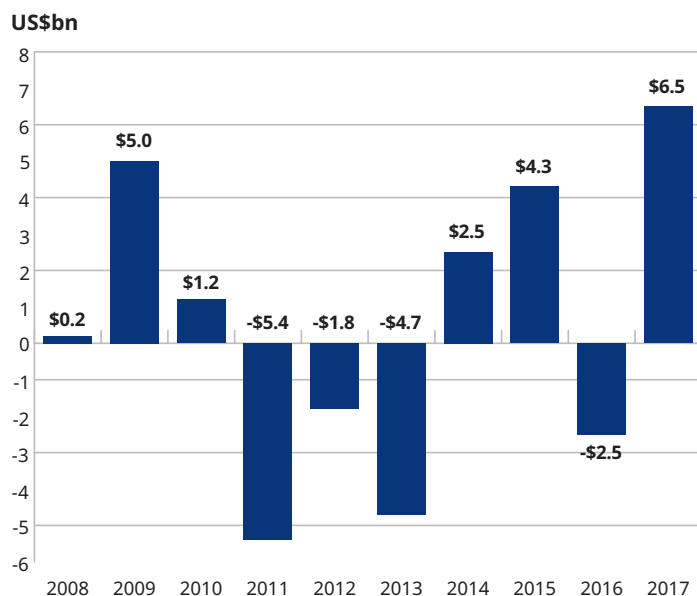


Data from 2003-2017. Source for both charts: Schroders and Thomson Reuters Datastream.

Active beats passive in Indian equities

The domestic Indian market is relatively open to international investors, in contrast to the Chinese market until recently. As well as consistent aggregate inflows (Figure 2), the attractiveness of the Indian market has led to robust inflows to offshore Indian funds from global investors over the last few years, as shown in Figure 10.

Figure 10: Flows into India funds have been strong of late



Source: Morningstar, as at 31 December 2017.

As a result of these flows, total assets under management in India from dedicated offshore funds have reached close to \$55 billion. Interestingly, allocations are predominantly made to actively-managed rather than passive funds or ETFs. The share of passive funds has actually fallen from 25% to 20% of the total assets of India-dedicated offshore funds in the last two years. The same is true of flows from

domestic investors. The reason for investors' faith in active managers comes from their track record of delivering consistent outperformance. Over the last 10 years, the India-focused CRISIL-AMFI Equity Fund Performance Index has handsomely outperformed the main domestic benchmark, the Nifty 50 Index, on a net of fees basis.

Figure 11: Active managers have significantly outperformed in India

10 year performance (%pa)	
CRISIL-AMFI Equity Fund Performance Index, net of fees	8.9%
Nifty 50 Index	5.5%

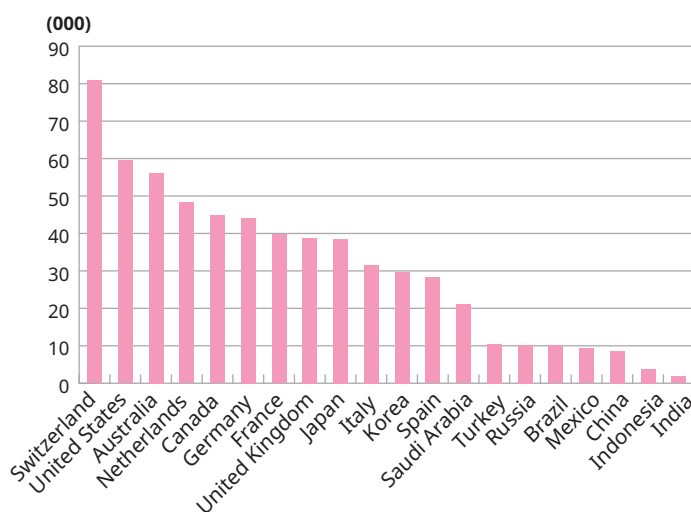
Source: Axis AMC analysis and CRISIL, part of S&P.

India is a market where the higher costs of active management have been decisively rewarded by excess returns.

The catch-up potential of the Indian economy

Despite rapid growth over the last 20 years, India remains a low income country and ranks poorly on several parameters. This is particularly apparent in the comparison of per capita income with that of other advanced and emerging economies.

Figure 12: The Indian economy still has a long way to go
Per capita income in US dollars

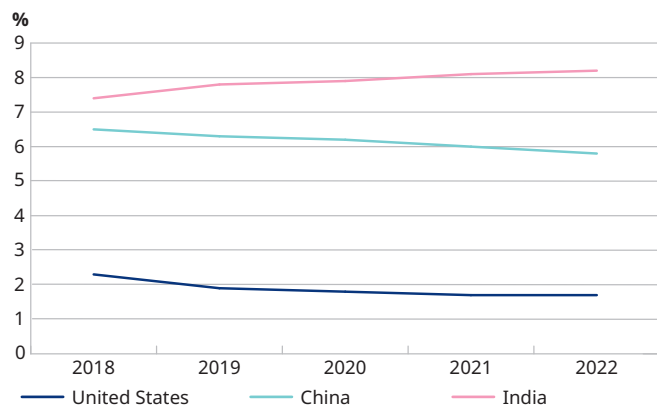


Source: IMF World Economic Outlook, October 2017

After a period of turbulence between 2010 and 2014, the economy is moving to a higher sustainable growth path. Cyclical recovery is now combining with structural reforms undertaken by the government over the last few years, including improving financial inclusion, increased ease of doing business and the implementation of a goods and services tax (GST). Figure 13 shows the IMF's forecasts for growth in the US, China and India out to 2022.

Figure 13: India is accelerating away from other big economies

GDP growth

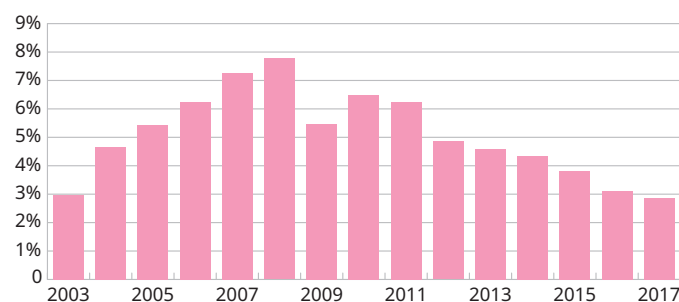


Source: IMF World Economic Outlook, October 2017

A recent Schrodgers paper² showed that there is often a significant gap between GDP growth and earnings growth in emerging economies. In India in the next few years, however, we expect economic growth to flow through to higher corporate earnings. Recent economic challenges have left corporate earnings at a cyclical low relative to GDP and there is room for earnings growth to outpace nominal economic growth (Figure 14).

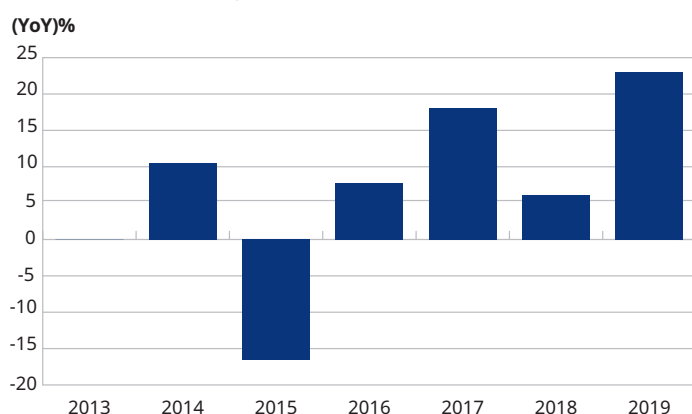
Figure 14: The decline in corporate earnings looks set to reverse

Corporate profits/GDP



Source: Capitaline and MOFS

MSCI India earnings



Source: Bloomberg, as at 28 February 2018

Leapfrogging with financial technology

The informal and cash-heavy nature of the economy (which was highlighted by the impact of the withdrawal of high-value banknotes in late 2016) has extracted a heavy price from India in terms of inefficiencies and holding back growth. However, this scenario is changing dramatically. Technology is driving substantial productivity improvements and will, in time, drive a higher sustainable growth path. India is a leader in emerging countries in using technology to transform its financial system, including e-authentication, financial inclusion and payments infrastructure, giving its entire population the opportunity to participate in the formal economy. It is estimated that digitisation could add 50-75 basis points to India's GDP growth rate³.

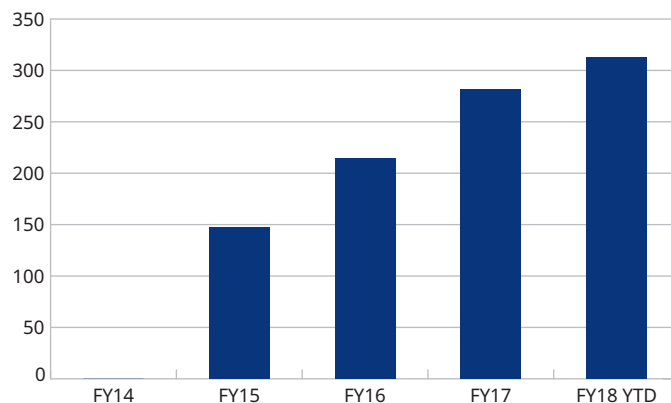
The three pillars of the so-called "JAM trinity" driving this digital transformation are:

1. **J**an-Dhan Yojana (financial Inclusion)
2. **A**adhaar (national biometric ID)
3. **M**obile services (connectivity)

Prime Minister Narendra Modi's Pradhan Mantri Jan Dhan Yojana (People's Money Scheme or PMJDY), aimed at improving financial inclusion for all households, was launched in 2014. The scheme has led to the opening of more than 300 million new bank accounts since its launch (Figure 15) – including a world record number in a week (Figure 16) – and has ensured near universal banking coverage at a household level.

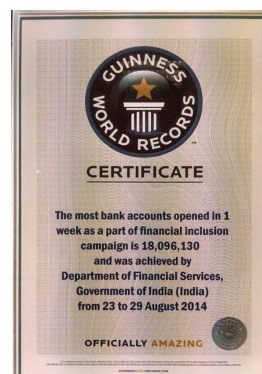
Figure 15: Financial inclusion has soared under Modi's PMJDY...

Millions of bank accounts opened



Source: Morgan Stanley Research and PMJDY Website, as at 29 November 2017

Figure 16: ...to record levels (and that's official)

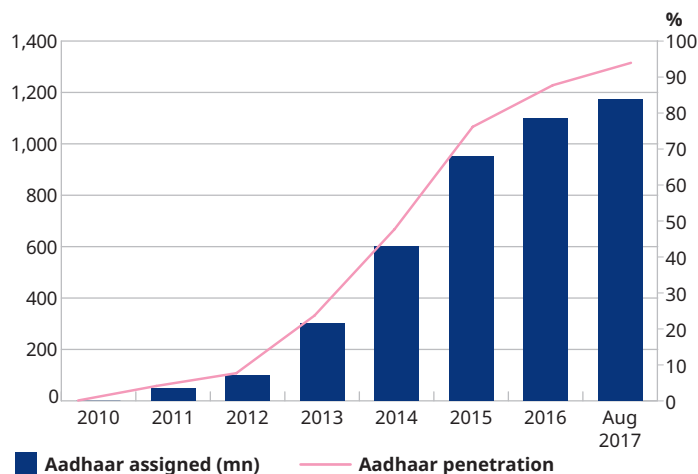


Source: PMJDY Website

³ India's Digital Leap - The Multi-Trillion Dollar Opportunity, Morgan Stanley, September 2017

The success of the PMJDY has been made possible by the backbone created by Aadhaar. Aadhaar is the world's most ambitious national identity project, aimed at providing the nation's population of 1.3 billion with a permanent, unique and secure identity based on their biometric data. From what was virtually a standing start five years ago, almost 80% of the population had been covered by August 2017 (Figure 17), a hugely impressive achievement. Aadhaar gives industries like telecoms, banking and insurance an easy way of digitally authenticating their customers. This should facilitate accelerated penetration of new goods and services.

Figure 17: Biometric data now cover most of the population

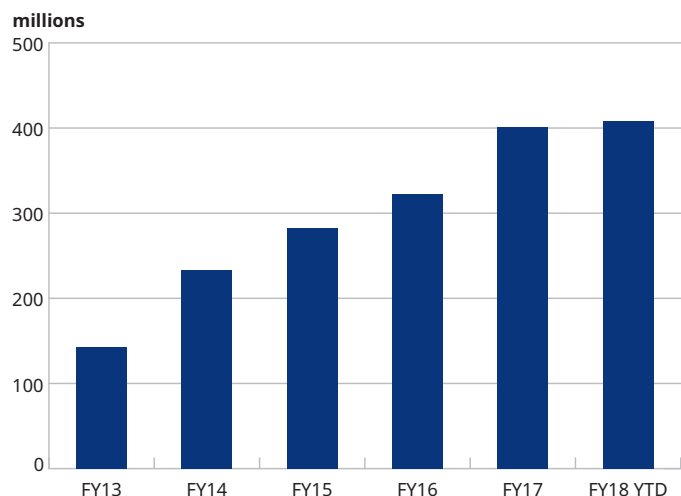


Source: Morgan Stanley Research and UIDAI, as at August 2017

The advent of affordable smartphones and fast 4G networks is revolutionizing connectivity. India has the world's second-largest internet user base. Further, it is a leader in mobile internet usage, with close to 80% of its web traffic accessed through mobile phones (as compared to around 55% for China and a global average of 50%). This is giving rise to unique mobile-first business models and is reshaping industries, including e-commerce, entertainment and the sharing economy.

Figure 18: Internet coverage appears close to saturation point

Total data subscribers

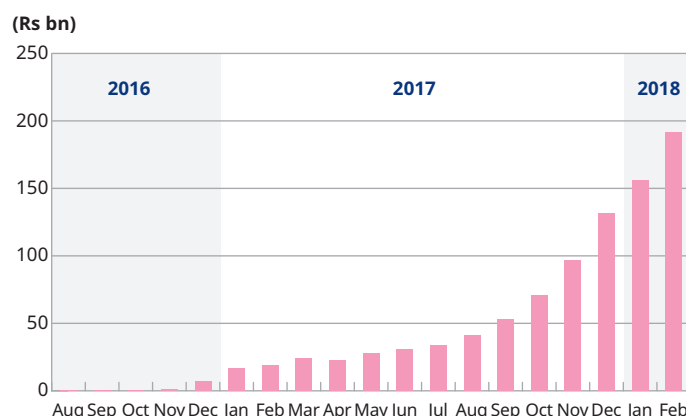


Source: Company Data, IDC, Morgan Stanley Research and TRAI, as at 30 September 2017

The JAM initiative has been kicked off with the insertion of mobile and Aadhaar numbers in all bank accounts. This is reforming public service delivery in India, with the removal of fake beneficiaries and a reduction in inefficiencies and middlemen by allowing for direct transfer of subsidies and other benefits from the government to citizens.

Technology is also allowing for dramatic changes to the payments infrastructure. Aadhaar provided the framework for the launch of a national digital payment system – the Unified Payments Interface (UPI) – that allows users to make money transfers with their mobile phones. In a country where cash has been king, mobile-based digital payments are completely changing the landscape. In the two years since its launch, UPI has become the preferred payment system in the country and is allowing all sections of the population to participate in the formal economy.

Figure 19: Payment processing has gone mainstream
UPI Transactions Amount



Source: NPCI

The economy has moved towards even greater formalisation with the implementation of a GST in 2017 – the biggest reform attempted in the country for a decade. The backbone of the GST is a digital infrastructure that allows for online matching of invoices and returns. The combination of this and digital payments is likely to create a huge big data opportunity that could transform small and micro business lending in India, further encouraging start-ups and innovation.

To summarise, smart use of technology should allow India to unleash its bottom-up potential and substantially raise its growth rate.

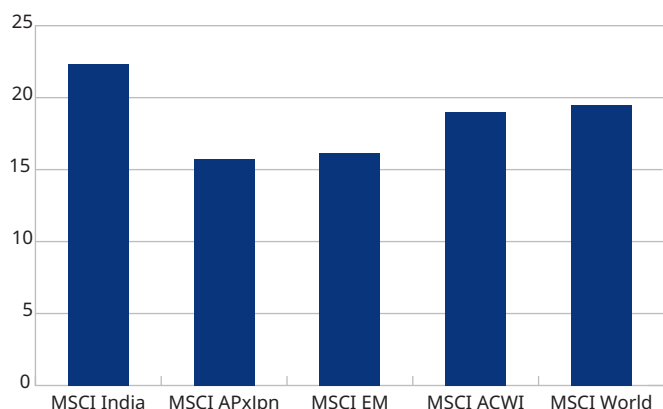
Possible near-term concerns

While the long-term investment outlook for India is robust, there are near-term challenges.

The foremost issue that resonates with most investors is the prevailing market valuation, although this is an issue facing many other equity markets. As a result of the run-up in the markets in the last year, India is trading at a premium both to its own trading history and to other Asian markets (Figure 20). As mentioned earlier, the higher valuation is partly explained by earnings being at a cyclical low. A strong earnings rebound in the coming years will normalize valuations to a certain extent. Also, the higher PE multiple reflects recognition of India's high rate of growth. Seen in this way, India's higher valuation is consistent with its status as a higher-growth market.

Figure 20: Indian equities are highly valued relative to rivals and their own past

Price/earnings (PE) ratios



Source: Thomson Reuters Datastream, as at 31 December 2017

MSCI India PE



Source: Thomson Reuters Datastream, as at 31 December 2017

A further concern is the state of the public sector banks (PSBs). These banks have high levels of bad debts which make them unable to provide credit to the economy. The bad debts arise from two key issues:

1. Excess/misdirected investment in the previous cycle (2009-2012), mainly in the commodity, infrastructure and power sectors. Many of these projects became unviable once the cycle turned.
2. Weak internal systems as well as crony capitalism which led to misdirected lending or frauds at several banks.

While several high-profile frauds have caught media attention of late and governance in the banks will need to be strengthened, we believe the key reason behind the scale of non-performing assets has been the aggressive investments made at the peak of the previous economic cycle. The government has taken concrete steps that will strengthen PSBs in the medium term, including pushing for the recognition of non-performing assets, a faster resolution and bankruptcy process, and a commitment to recapitalisation conditional on the banks strengthening their internal processes. Indeed, the early example from the big loan cases that have been taken through the newly set up bankruptcy resolution process has been quite encouraging, with several projects (for example in the steel sector) likely to generate better recoveries than expected. Furthermore, the economic effects are being mitigated partially by the robust state of private sector lenders (both banks and non-banks), which have stepped in and are taking market share from the PSBs.

India's political calendar may be another influence on market sentiment. The next elections are due to be held by May 2019. Higher political uncertainty may be a temporary dampener for the market, but there has been remarkable continuity in the economic policies followed by different political parties and, given the strength of Indian companies, elections are unlikely to lead to any lasting negative shock for the market.

Conclusion

As India moves to the heart of the global economy, investors can no longer afford to ignore the tremendous potential of its markets. The equity market is relatively richly valued, but in our view deservedly so, and we anticipate significant future earnings growth. The depth and breadth of the Indian equity market, and therefore potential upside, is unlikely to be fully captured by exposure within a global or regional mandate. The distinctive feature of Indian equities (which also makes this market fertile territory for active management) is the scale and dynamism of the small and mid cap sectors, which are not fully represented in global benchmarks. To address this imbalance in global portfolios, we recommend that existing large cap exposures to India should be complemented by a stand-alone investment that can exploit the full spectrum of opportunities in the equity market. As ever, with single country emerging markets, the investment risks are higher than in developed markets. They include foreign exchange risk, political, legal, counterparty and operational. All these factors mean that investors may not get back what they originally invested.

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