EMERGING CANVAS OF INVESTMENT - OPPORTUNITIES AND RISKS

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This article walks us through the opportunities and risks of investing in India. People are all ears to the India story, the author takes us through the risks and opportunities. Dr Uma Shashikant is a founder and chairperson of CIEL and holds a doctorate in finance. She is well known as a writer, speaker, researcher, consultant and trainer.

India as an investment opportunity is a theme that has persisted for a long time, since we opened up to global capital inflows in 1993. The novelty about India as an emerging market was very high in the initial period, and then the story was tempered by several ups and downs in the last 25 years. There was a time when the primary attraction of India was its insulation from global markets, evidenced by a low correlation with most markets. During periods of crisis and collapse elsewhere, Indian stock markets seemed unscathed. All that changed soon. By 2007 it was clear that India was not decoupled from the world, but quite amenable to being impacted by global head winds. Investing in India still remains an attractive proposition, both for global and local investors due to the sheer opportunity for growth.

The attractiveness of emerging markets like India, and the returns such markets offer to investors arising from the potential that a growing economy offers. Benefits of market expansion, development of new technologies and innovations, growth in infrastructure, services and manufacturing sectors, higher rate of GDP growth compared to the rest of the world, stability from elected governments, free press and democratic traditions, and modernisation arising from increased exposure to the world, are all enduring factors that make India an attractive investment story. Domestic investors who in the thick of all the action taking place, are better poised to make the most of these opportunities. Several institutional investors, domestic and global, view India as a very profitable long term investment play and returns on investments corroborate that assessment.

QUALITY CONCERNS

Where do the risks lie? The primary risk to an investor in India is the quality of businesses they choose. Private equity investors are quite used to an intense search for investment opportunities, but they would also testify to the difficulties in finding good businesses to invest in India. There is an underlying culture of exploitative capitalism in play, made worse by favouritism, corruption and lack of enforcement of the rule of law, that make Indian markets very risky to the investor. There are innumerable examples of business success that came about not because of innovative entrepreneurship, but mere crony capitalism at play. It takes a while to understand how nefarious players could spoil otherwise thriving and growing opportunities in coal, power, mining, roadways, banking, real estate, jewellery, and airways to name a well-known few, to short cut the process for private profits. Many businesses have emerged to be a kind of mafia in their own right, encumbering upon public goods for private gains, making many investors wary.

There are world class businesses that India has built; there are innovations that the country and its entrepreneurs can be proud of; there are foreign collaborations that have worked excellently to bring quality products to India and benefit from the growing markets here. However, to the discerning investor, the problem of not knowing whether a business succeeds from strong strategy or the existence of crony capitalism hiding from plain sight is a tough one. Selecting the right businesses to back remains a challenge for the investor in Indian markets.

The second big challenge to investors is the burden of historical baggage. Nowhere is this evident more starkly than in the banking sector in India. The policy misstep of nationalising banks many years ago and stripping the banker of accountability in lending decisions has created tremendous damage to the banking sector. Despite the opening up of the sector to competition and the implementation of various recommendations to strengthen the system, the problem of poor quality assets has only grown with time, and is now large enough to threaten the existence of erstwhile strong banks. From a time when we believed that the public sector would lead the economy and build institutions of benevolence in a socialistic model, we have taken a turn to embrace capitalism and the market economy. However, we still have several businesses owned by the government in a range of sectors from airlines, mining, transportation, metals, beverages, hotels, telecom, and insurance. While accepting that the government has no business to be in business, we have neither privatised these, nor dismantled the bureaucracy that supervises them.

To the investor, the existence of these pockets of inefficiency that simultaneously enjoy government patronage, is a risk. How would one evaluate the banking sector, for instance? Would one see it as a growth business that can exploit the low penetration of banking services, the huge potential to expand credit, and the opportunity to formalise several informal sectors? Or would one see it as a risky business with a systemic risk of a possible bank failure from NPAs? Or is it a sector with the lack of clear policy guideline with respect to the treatment of a bad asset, its recovery and rework of the balance sheet? To an investor the presence of historical baggage is an unresolved risk that makes an investment decision needlessly complicated.

There are always fears of the immediate events and factors that may matter in the foreseeable future. That 2019 is an election year is a factor that weighs on the minds of several investors. They would worry about policy decisions that pander to the electorate and interest groups of the ruling party, and about reckless decisions with an eye on the ballot. Or they would worry about possible destabilisation from a result that may not bring a majority government. One of the primary reasons for our inability to forge ahead the path of reforms we set upon in 1991 has been the various ragtag coalitions that have ruled the country and investors continue to be wary of that risk. However, the resilience of Indian businesses to the political risks and changes in the parties that ruled has also been established in the last 25 plus years. Therefore the long term investment story for India is more about the opportunities offered to businesses by the unique factors that enable growth, than about the risks from the political environment.

Enough has been written about the demographic advantages of India, the high GDP number, the opportunity for the economy to double in record time, and the growth from growing global exposure. Let's consider two overarching themes that will matter to the long term investor, who would like to stay invested and make the most out of the opportunities offered by an emerging economy like India.

The first theme is the consumption story that will primarily drive India's growth and offer the highest potential for investment returns. The second theme is the one that will temper these returns and remain outside the realm of control of the investor – the changing global trends. An investment strategy that considers both these factors is likely to benefit the investor the most, in terms of balancing risks and return.

CONSUMPTION

The Indian consumption story has been told with various modifications and nuances ever since the economy opened up in 1991 and the theory that consumers will propel growth gained ground. The liberalised Indian market place of the last 27 years has been undoubtedly driven by consumers. Most sectors that saw significant growth and gains in those years, from telecom to automobile and tourism to fashion have benefitted from the ability and willingness of the Indian middle class to spend more. Boston Consulting Group estimates that India's household spending will triple to $4 trillion by 2025. The middle class is estimated at 600 million, a number that is about twice the population of the US, about 60 million short. It is tough to ignore the impact of the wallet of the middle class Indian.

The consuming Indian had not been easy to stereotype. Many global brands have watched in dismay when fake versions of their produce flood the market with cheap lookalikes. They reported that the Indian consumer was willing to compromise quality for price. Even before they began to generalise that Indians may be unwilling to pay top dollars, the expansion of the markets for luxury goods left most observers stumped. From luxury homes to cars, jewellery to destination weddings, Indians seemed quite willing to splurge. Early observers looked at urbanisation as the trigger for consumption. Soon enough, the demand for goods and services from rural markets began to outpace urban markets, and many producers modified their strategy to capture the imagination of Bharat, rather than India alone. Before we theorise that the new demand will be driven by the millennials, there are studies that show the emerging spending power of the newly retiring Indian who is ready to buy more toys, travel the world and pay for a new experience. Tracking the trends in the Indian consumption story has thus remained a challenge. The risk in this sector also stems from these changing assumptions about consumer spending.

We can divide consumption into two categories – essential and discretionary. The rate of growth in discretionary spending is estimated to be much higher than the rate of growth in essential spending. There are two primary reasons: First, the rate of inflation that applies to essentials has been lower, while prices of discretionary items have been increasing more rapidly. Second, the availability of bank loans and the increased use of formal credit by households has enabled a higher discretionary spend. The amount a household spends on transport and travel is no longer dictated by cost of public transport, when it is easier to obtain a bank loan and get to work in a personal vehicle.

The investment opportunities triggered by the consumption story are quite vast, wide spread and subject to a steady and sustainable growth over a long period of time. A long term investment strategy will ride the consumption story and the growth prospects it holds. Food and beverages, alcohol and entertainment, clothing, fashion and accessories, automobiles, telecom, housing and communications are all sectors that directly benefit from the Indian consumption story.

Investors in the consumption driven sectors have a diverse range of opportunities: Several PE firms and boutique investment firms routinely chase consumption stories for their growth opportunity. Portfolio managers offer thematic plays that focus on consumption to provide a concentrated bet; mutual funds offer both diversified portfolios and thematic funds to capture this opportunity; and the simple low cost index funds offer a diversified bet that also has significant weightage to consumption stories. Growth investing in India would not ignore consumption driven sectors.

GLOBAL TRENDS

The changing world order is always a challenge to investors. Much as one would like to invest within the local context and primarily in domestic businesses, the performance of those businesses as well as the stock markets where these businesses are valued, are significantly impacted by global trends and policies of various governments. Returns and risk of various asset classes is impacted by these global trends. The emerging risks to oil from the growing tension in the Middle East, and the broad projection that we are headed towards $100 per barrel for crude, alters so much for the Indian markets. As a net importer of crude, and as a country with high dependence on oil and a lower level of export engagement with the world, rising oil prices will impact our balance of payments, lead to a depreciation in our currency, and also impact our fiscal balances.

There is then the question of FII flows, which are impacted by both strategic and tactical allocations based on the global trends. If there is a negative global outlook arising from rising oil prices, tense global trade and policy relations, and uncertainty about the direction the developed world would take, overall strategic allocations to emerging markets would fall, as money remains risk averse and in home markets of global investors. In that context, the tactical allocations between various emerging markets and the relative share of India in global capital flows would not matter much. It is an overall positive scenario for global flows that the relative attractiveness of India in terms of its GDP growth, market performance, domestic consumption and investment, and quality of government and policy will matter more.

The risk of a no holds barred trade war will have its own ramifications for the global economy, and most leaders are keen to avoid an escalation of the retaliatory stance on tariffs and protection. Years of work done by the WTO to dismantle destructive tariffs are now under the risk of being undone, and the carving out of nations by their protective measures will impact many economies. Given India's limited engagement with the world, this may not seem like a big impact on our economy, as compared to other export-dependent regimes. However, global trade wars combined with restrictions on immigrants in Western economies can seriously impact technology and services businesses.

The interest rate cycle is another matter of concern. While India has begun to increase its rates, it does seem to have done so reluctantly, and the expectation that US would not increase rates too much too soon underlies the monetary policy assumptions of many economies including India.

However, it has become quite complicated to venture into the business of projecting how the developed economies, especially the United States would perform in the next few years. While there is optimism about resilience and revival of the economy and the possibility of a sustained 4% GDP, there is worry about the trade and tariff policies unraveling to the detriment of the US. Many Western nations as well as exporters like Japan and China, and many nations in Asia and the Middle East are known to be grouping up to work together in the light of what is seen widely as disruptive trade policies of the US. Greater the unknowns, greater the risks to the investor.

PLAN OF ACTION

How does an investor develop a strategic outlook for investing in the Indian markets given these opportunities and risks?

First, every market offers the opportunity for beta returns that come from investing in the broad market and the alpha returns that come from outperformance. Investors should target a combination of the two. It is quite common for investors to focus too much on alpha. Many would think that investing in equity is not worthwhile if extraordinary returns are not earned. It is important to see that stable long term story that India represents is best captured by the index or a diversified portfolio of stocks that broadly invests across sectors. Such a portfolio may not include the spectacular stars, but it holds the merit of being a default choice to invest, an easy decision to make during all times, a theme that is worth investing in for the long term, and being diversified a low-risk choice for most investors. A diversified portfolio that offers market returns should be the base, over which all else can be built.

Second, the dilemma of large cap versus mid cap is a tough one to resolve in the Indian markets. While large cap stocks offer stability, the returns from the mid cap opportunity is too high to ignore. In an emerging market like India, it is the business that begins small, shows agility to grow rapidly, and become a blue chip in a short span of time, that holds investor interest. There are several examples of business that became big thus. However, the risks of failure are high in the mid and small cap space as not all businesses succeed in what they set out to do. An investment strategy that has a core and a satellite component, with large cap as core and mid and small caps as satellite would help balancing the portfolio. The relative weights can be modified to overweight large caps during times of uncertainty and overweight mid and small caps during times of optimism.

Third, investors love the idea of being value driven and like to see themselves as chasing good investment opportunities at a reasonable price. However, a market like India offers more opportunities for growth and momentum, than value. A beaten down business may not represent a cheap buy, but an incorrigible loss. Most money in Indian markets has been made from growth and momentum than from value. Momentum is risky but holds the lure of a quick gain, making short term day traders out of once innocent bystanders. It is astonishing how many try to make money staring at blinking screens and staking too much money on what they see as going up. Investors have to make their choices – to invest is to choose carefully and focus on the return; to trade is to have an algorithm or action plan and focus on the capital. The two are completely different tactics and need different kinds of skills and attitudes.

There is money to be made in the long term on a diversified portfolio across sectors, built carefully, monitored regularly, and pruned sensibly. It just boils down to implementation, which most investors admit is tougher than assumed. ■