Building portfolios and solutions for the Indian opportunity

Some of India's top asset managers came together at a recent Hubbis roundtable in Mumbai to discuss how the industry needs to approach education for investors and distributors – and ensure portfolios can be built to tap the market potential over the long run.

Participants

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HOW WOULD YOU EXPLAIN THE INVESTMENT OPPORTUNITY INDIA REPRESENTS TO AN INVESTOR THINKING ABOUT THE NEXT 5, 10, 15 OR 20 YEARS? WHAT WOULD YOU ADVISE THEM TO INVEST IN AND WHY?

Basu: Before you talk about the investment opportunity and start a conversation with a client, I think the most important thing is to explain to the client why they are investing, the appropriate behaviour and approach to investing, and mutually deciding on the key investment goals.

What makes sense and what is sensational are two different things. What makes sense in a portfolio is asset allocation and the duration that the client holds a product for, while keeping emotions at bay.

Those are the things that are sensible for investing, but investors get carried away with things that are sensational yet have very little impact on the portfolio returns.

If you look at the equity and debt markets in India today, there are some things that are clearly working in your favour. The current account deficit and the fiscal deficit are slowly coming under control, the inflation is coming down to moderate levels and the government is making the right kind of noise in terms of fiscal consolidation. Overall, you are in a situation where the economy seems to be slowly recovering from the lows.

Once growth returns, it will be easy for corporates to start earning and producing better ROE, which is where the opportunity lies in the equity markets.

Having said that, the markets have run up in the last two years, on the basis of expectations of earnings growth. This has to come true for the markets to sustain. We see some pockets of opportunity in some spaces across equity markets, where key things like earnings growth and pricing power has returned and where the industry is consolidating.

People today are expecting a V-shaped recovery but they may be disappointed for a few reasons. Primarily, the balance sheets in corporate India are massively leveraged and that is going to take time to return to normal. The leverage, in turn, puts the ROE under pressure, which in turn affects the ability of the business to invest more capital since the risk-free rate in the market is as high as 8%.

Under such circumstances, you have to be a patient, long-term investor prepared to weather the short-term fluctuations and keep emotions out of it.

This is also true of debt markets. We think that long-term debt is the best way to participate in the markets.

There are two legitimate ways to allocate to debt: one is duration and the other is credit.

We believe that the nominal GDP of the country is a reflection of the capacity of an economic agent to service a debt. If the nominal GDP is growing, it means that the economic agents or producers of goods and services have got ample capacity to service debt. This was the case in 2009 where everybody was working to make sure that the nominal GDPs go up because there were liquidity concerns and huge stimulus packages were being doled out around the world. Over the last few years, however, the nominal GDP has come down.

This means the ability of economic agents to service debt also is reducing, at least in some pockets. This signified that you have to be very careful in terms of choosing what kind of debt strategy you prefer as an investor.

We think the balance today is tilting toward a duration play rather than a credit play, in India.

ARUN SUNDARESAN
Reliance Capital Asset Management

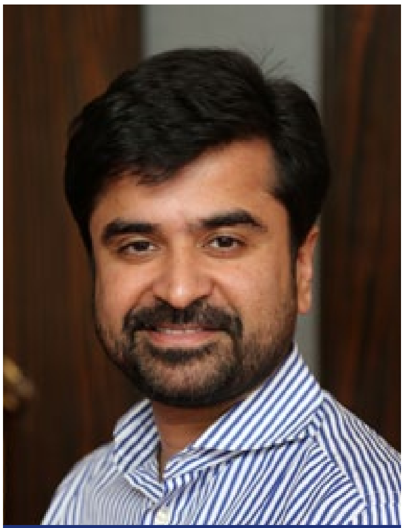
"You have to be a patient investor prepared to weather the short-term fluctuations and keep emotions out of it."

Sundaresan: India's household financial savings is about USD 150 billion per year whereas combined assets in the Indian mutual fund industry is about USD 200 billion.

The industry has picked up flows over the last year and so. The last few months have showed an average net inflow (inclusive of systematic commitments) of about USD 1 billion per month in equity schemes. However, it's still below the potential. Investments from the household sector can possibly complement FII flows. FIIs invest on an average about USD 13 billion to USD 15 billion in equities per year. Domestic investments into financial assets can significantly go up from the current low levels. At present, Indians have a high inclination towards investing in physical assets. In India, equity assets total about USD 300 billion you can say, whereas gold is estimated to be about USD 1.5 trillion and real estate is estimated at about USD 12 trillion.

While we are quite happy about the way things have started picking up in the last one year, much needs to be done in this space. Hopefully, with more people becoming aware of the potential returns and benefits, more people are likely to invest, which should go very well for the markets.

We have been optimistic about equity markets for a while now and will hold on to our optimism, regardless of global volatility resulting from the situation in Greece yesterday, China today or the Middle East tomorrow. These things cannot be anticipated or planned for. Our fundamentals are fairly robust and we have seen a lot of macro improvements. Inflation has come down, the government is making visible efforts for fiscal consolidation and reducing the



AASHISH SOMAIYAA
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current account deficit, been fiscally prudent by reducing spending on the populous subsidy schemes which is a good thing from a market perspective. What is important now is the implementation of the reforms which will help the earnings to pick up.

As far as fixed income markets are concerned, we are in a very sweet spot. Unlike equities, we are not dependent on foreign flow as the overall fixed income exposure of foreign investors is only about 2% of the outstanding holdings. As a result, it is more domestic focused. The real yield across the curve has been positive and relatively high, making us optimistic on the fixed income space.

Somaiyaa: Whenever there is a crisis that hits the shores, there is some kind of trigger. A 6% fall in the market in a single day in China is definitely a big trigger that points to the fact that there are definitely some serious issues out there. I think it would be very unrealistic to assume that we have heard the last of it and from here on there is going to be a V-shaped bounce back.

This is not the last of it – in fact, this is the beginning of what has started to emerge. Over the next six months to a year, there is going to be a lot of turbulence as far as global factors are concerned. Only when the US does actually get into a lift off, the deep issues related to China will be discovered and the related domino effects will be felt. China is a major trading partner because it is a major consumer & supplier of a variety of products.

The first time the market falls 6%, you don't see the complete spectrum of damage but I think there is going to be a good amount of domino effect and there will be collateral damage.

As far as next few days or few weeks are concerned we would be circumspect and closely watch what is happening. As far as India is concerned, somebody recently joked that there are more number of traders who have been waiting for it to rain than there are actual farmers who have been waiting for it to rain.

That's just an indication of the kind of scenario we have. The best of fund managers and analysts today constantly complain about the hawkish nature of the RBI governor, that the government is not delivering, and about the uncertainty in China.

Since the time the new government was formed last year, a lot of people have positioned their portfolios for a high beta kind of activity, which is not totally wrong. Last year, just before the election results came, April and May 2014, the Indian equity market was absolutely indiscriminate. It didn't matter what stock you were holding, everything was just flying. Then, all of a sudden, there was this feeling that the government isn't delivering, it is not raining enough, the RBI is hawkish, the international scenario is not playing out as per as expectations and so on.

There is a huge number of people who have positioned portfolios for a certain kind of environment and they have invested in a lot of companies where the locus of control is in the environment and not in the company itself. A lot people have made investments based on a top-down macro analysis and the environment is not very suitable at the moment. The next one year is going to produce mixed results and people will have a tough time, depending on what they've bought and where they are invested.

THERE SHOULD BE A SOLUTION-BASED CONVERSATION BETWEEN AN ADVISER AND THEIR CLIENT WHERE THEY TAKE A VERY LONG-TERM VIEW IN THEIR INVESTING. HOW SHOULD THE CLIENT THINK ABOUT THEIR SAVINGS OR INVESTMENTS?

Somaiyaa: Serious long-term wealth creation happens when you invest in companies which have a sustainable earnings trajectory – which is why we propagate this ideology about buying right and sitting tight.

We look to invest in companies with three serious attributes. One is business and management quality, second is growth orientation and the trajectory of earnings growth, and the third is longevity or sustainability. If a company

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has these three attributes and all this is quantified, then we look to buy at a fair price.

The entire thought process is around avoiding investment in companies whose control is way away from the company and more centred on the environment and macro developments.

Since the macros have gotten very challenging, our investment philosophy stands out when we have conversations with clients. At a recent conversation with private bankers evaluating our fund which has a portfolio of 15 stocks, the discussion was centred on every stock that we hold, why we hold it and the outlook for the next few years since the portfolio was strictly bottom up.

At the end of the meeting, they complemented me because they had a similar meeting last week and the entire discussion was on the macro and the environment. That's where the difference lies. When you are buying companies with the clear understanding that wealth will be created only from their earnings, and you are buying it strictly on a bottom-up basis, you try to keep your portfolio as sheltered from the macro as possible.

I am not saying that top-down never works, but the last six to seven years has become extremely difficult.

Sanghavi: To have a long-term view on investing in equities is great. The only problem with this is you have to counter the behavioural aspect of an investor. If everybody understands and invests for the long term, then there would be massive creation of wealth but that doesn't necessarily happen.

We have seen time and again, peak inflows coming into equity markets at the time of maximum euphoria. You can take any historical period for example, you will see maximum interest by retail investors coming at the peak of the markets and leaving when the market bottoms out in a year or two.

In equities, long-term is normally three to five years at least. If it is three to five years, one has to understand that there are possibilities of draw-downs and if somebody is not comfortable with the draw-downs, you should look at alternative products and a longer term. On the debt side, in a decreasing interest rate scenario, I think all goes well for fixed income guys. However, for serious wealth creation in equities in the long term, one has to truly understand the behavioural aspects.

IF YOU ARE IN YOUR MID-20S AND IT'S A 30- TO 50-YEAR ENGAGEMENT, NOT THREE TO FIVE YEARS, TO WHAT EXTENT DO YOU THINK THE INDUSTRY HAS TO THINK MORE ABOUT SOLUTIONS AS OPPOSED TO PRODUCTS?

Sanghavi: Retirement and pension products are for the longer term and can create some good wealth.

However, the level of education and the level of awareness around the products are pretty low and there aren't many products available.

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The mutual fund or the pension fund industry can come up with different kinds of product for investors and I would like to see an allocation towards these kind of products for longer term wealth creation in the portfolios.

As an industry, I think attracting investments into these products needs a huge amount of education. First of all, to get investors to give mutual funds a chance, and then retirement and pension funds. It needs a logical evolution.

Sundaresan: Today, not investing in equities is actually a risk for Indian investors. Their allocation to equities as such is very low. Whether you look at a 20- or 15-year time frame, or even in a short tenure like three to five years, the returns have been fairly good. Probably the benefits of equity investments are not understood well enough and the risks are over emphasised.

Equities have given fantastic returns. To give you some perspective, we have this fund called Reliance Growth Fund we launched in 1995, INR 0.1 million (INR 1 Lakh) invested then is worth INR 8 million today which is a compounded return of close to about 26% after expenses. If you look at the stocks during this time, less than 3% or 4% of the stocks have given better returns.

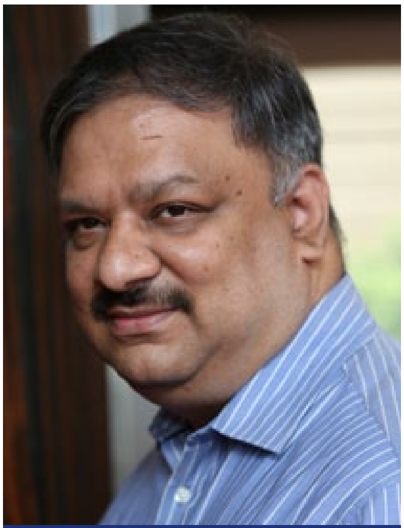
For the longer term, when you believe that India is a developing economy, it will grow well, the conclusion is that equities will do well and professional fund managers should do much better. That's what history suggests.

We of course adopt a very diligent approach towards investment by asking the right questions: which companies are most likely to benefit in this environment? Pick up good quality companies which are likely to sustain their earnings and profits over a period of time.

That's how we have created wealth over the years.

In terms of products, we offer a variety of products to suit different requirements within asset classes. For example, funds which focus on the large cap-oriented companies and those that focus on mid-cap companies, there could be quite a bit of difference in their performance. Then, there are a whole lot of products which have varying components of equity and debt. There are products which allow you to invest in international markets, and there are multi-asset kind of products which allow you to automatically switch between different asset classes.

Increasingly, the industry, and we at Reliance in particular, is slowly trying to move towards a solution-based approach. Recently, we launched a retirement fund, and we designed the product in a very simple manner to take care of the different stages of retirement. The stage before retirement in which you need to accumulate wealth is dominated by equities and the post-retirement phase is dominated by debt which has a component of equity to take care of inflation in the post-retirement years.



AMIT BASU
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WHERE CAN AN INVESTOR FIND VALUE IN THE MARKET?

Basu: If you want to understand the basics of making alpha, you must understand "EFGH".

They stand for emotions of fear, greed, and hope – and that is one of the key parameters on which you decide whether you make alpha or not.

If you are a victim of fear, greed, or hope, the chances are that you will not make alpha even if your portfolio has the right qualities. The second is the fact that investors are a big believer of the laws of physics, which dictate that there is the action and reaction phenomenon. Whenever this law of physics is broken, where you find that you have not done any action but the reaction on the portfolio just taking the wealth away, emotions creep in. If you go to a bank and place your money in the bank fixed deposit (FD), unless you do something there is no reaction happening on the FD. If you buy a fixed income instrument which has a maturity, which is defined maturity, if you don't break that maturity instrument, there is no reaction on your portfolio valuation.

When you enter the market, and the law of physics is broken, that's when emotions come in and it's very important that we have a huge emphasis on behaviour rather than portfolio as the first principle.

This should be the first thing we teach investors. Having explained the importance of behaviour and emotions, to investors, we try to educate the distributors and advisors about the behaviours, biases and the risk that investors go through and how we can handle them better.

As a result, it's not a one way programme; we also share with distributors where they can handle their clients better on their behavioural aspects.

If you specifically come to the market and look at the alpha, we divide the market into four broad categories: banking and financial services; growth and investment economy; consumption; and exporters.

Under these four categories, we analyse the market. Banking, I think the PSU banks are still under a lot of stress and there are mixed bag result in Q1. We are more concerned and keen to partner with private banks who are running a retail franchise and a retail lending book or with an NBFC than a PSU bank at this stage.

On the investment side, we see a lot of announcements by the government on infrastructure investings, but it's actually limited to a few pockets, especially roads, ports and EPC sector, and now portfolios are getting aligned.

We are not making a case for infrastructure, but only for select pockets under the infrastructure theme where we see a lot of earning feasibility.

On the consumption side, there are pockets where we see some earnings growth happening, in terms of discretionary spends, companies are getting that advantage.

On the export side, we think technology has to reinvent itself. The word "digital" is taking things in a different stream altogether.

The key is the ability of IT companies to reinvent themselves and understand the nuances of that space, and capture opportunities that are going to drive IT companies' earnings growth.

Another play on the export side is the pharma sector, where we play the large companies because they have more ability to withstand regulatory changes that might happen.

Sanghavi: Whether you talk about alpha creation on a relative return or an absolute return basis, it's a diverse set. We create alpha by generating absolute returns, consistently, year on year, irrespective of where the market goes.

For us, the definition of alpha is that, over longer periods of time, our objective is to generate about 15% to 20% year on year.

Right now, 15% to 20% doesn't look too exciting in a beta market like India but if you go back in terms of the data which is available from 2001, where the index has given returns of about 14% to 14.5% on a CAGR basis, achieving that 14% to 15% and outperforming is our objective on a longer term basis.

Somaiyaa: Clearly, if you think about delivering alpha to a client's portfolio, there are a few sectors that really stand out. Since we are strictly bottom up, our starting point is not really the sector but a search for where we are more likely to find some of the winners.

From that perspective, I think auto and auto ancillaries are clearly a choice because increasingly there are chances that India will turn into a global hub. Private sector banks and NBFCs are another choice.

Third is the FMCG sector in terms of white goods, apparels and textiles, for example. The fourth one is pharma.

A lot of times, there are couple of pitfalls when it comes to delivering sustainable alpha in India. One is that we try to time the cycle and display cowboy-ish behaviour. There is a huge issue as far as style drift is concerned.

Most people either do not profess to have a philosophy, or profess to have a philosophy but they don't follow it. From that perspective, we are very clear about what we will do, what are the do's and don'ts, and as far as delivering alpha is concerned whatever are our four or five kinds of favourite sectors.

AS INDIA MOVES IN THE DIRECTION OF PROVIDING ADVICE, HOW MIGHT THE FRAMEWORK EVOLVE IN TERMS OF MORE RATIONAL INTERACTIONS WITH DISTRIBUTORS AND ALSO IN RELATION TO HOW PEOPLE DECIDE HOW TO INVEST AND CREATE PORTFOLIOS?

Sanghavi: Since our product is pretty new to India and to distributors themselves, we have found that after initial apprehension, distributors are quite open to exploring the new idea of something called risk-adjusted returns.

Though a little slow, the fact of an alternative asset class apart from your normal traditional debt or normal traditional equity is starting to seep in and wealth managers are looking for products in these areas.

Having said that, we also see the Indian industry is slowly graduating towards active versus passive, in keeping with global trends.

The wealth managers, going forward will place a huge amount of emphasis on the process of investments, especially on passive or something like an ETF, whereas there will be a distinct class of active asset management which is aimed at absolute return generation.

Sundaresan: One of the issues is that most advisers go by past returns and tend to make decisions purely based on a quantitative assessment.

They may look at the last three years' data, for instance, to categorise funds. They may not necessarily look at the benefit of diversification that different funds could bring within that categorisation. So, merely by adding three or four funds, investors will not get the benefit of diversification unless the funds and their styles are different.

They need to pay more attention to that rather than only the quantitative assessment. The important point would be to understand the current context and how the funds are being positioned and marry that with their own view of how they think the client should go about it.

That's the way they should pick styles of funds, while the overall emphasis should be on asset allocation. Obviously, that has to be different for different investors depending on their appetite and the actual requirements.

Basu: Look at the way Indians have allocated their savings.

The bulk of it goes to real estate, gold and in the bank. And yet there are no regulations for the markets of gold and real estate.

So the first step should be to get more money into the mutual funds space and then we can start thinking about how to allocate between mutual funds. That has been a herculean task, and as an industry, we have not been successful so far for a couple of reasons.

"The important point would be to understand the current context and how the funds are being positioned and marry that with their own view of how they think the client should go about it."

First is that it's not important what you know; it's more important for others to understand how much you know.

We have been talking to clients and customers in a more rational way to tell them how we will invest their money.

However, they are interested to know what will happen to them if they give us money, not what we are buying.

That's where I think the insurance industry has succeeded because they have been able to tell customers what's going to happen to them should they give them money – whereas we have been talking about what we will do with the money that they will give to u.

For example, whether we will put in infrastructure, or a bank, or consumption, or whatever.

The communication has to be simplified and has to be made in a manner where the customer understands the benefits out of investments and that's where we are lacking.

Secondly, I think as an industry we have started work on financial literacy a little late and we could have been in a better position had we started the work on investor awareness earlier.

However, we are now on the right path and all of the mutual funds have now created investor awareness and financial literacy programmes.

Somaiyaa: I personally feel that as an industry of product manufacturers, we are not very clear whether we are a B2B or B2C industry.

We first need to be very clear whether we are communicating to the channel or to the investors.

When we speak about controlling or guiding investors through their own psychological biases, handling investor psychology is a distributor's job.

However much I do as a manufacturer, I have certain competencies.

As a result, it seems to be best that we stick to B2B and not confuse ourselves with what the investor wants, because I don't think that an investor who is catered to directly by a manufacturer is in safe hands. ■