INVESTMENT RESEARCH

Notes from the Road

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PATHSTONE
THE FAMILY OFFICE℠

WHAT CAN GO WRONG IN INDIAN EQUITY MARKETS?

Our Recent Trip

- As part of our recurring international research trips, three of us on the manager diligence team at Pathstone traveled to Mumbai, Singapore, and Hong Kong over the summer.
- Covering 12 days away, nine flights (five of which were delayed), and 22 investment manager meetings.
- As we returned home, we wanted to share a series of "Notes from the Road" to help frame some of the opportunities, risks, takeaways, and relevant thoughts as it relates to our client portfolios and existing manager allocations. The first of these Notes focuses on the Indian equity market.

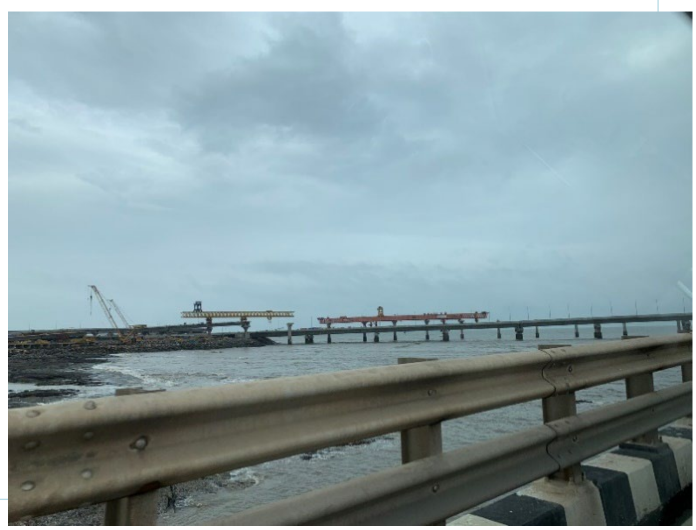
Why We Travel

- Supporting the significant existing client allocations to international equity markets.
- Our continuing mandate to find the most attractive investment managers around the world.
- Traveling to foreign cities affords opportunities to meet managers and investment teams on their home turf, to better gauge local talent and trends, and to meet managers earlier in their fund lives.

India is one of the few equity markets globally to have competed with the returns of the S&P 500 Index over longer periods, and investment managers with exposure to India have benefited from it. A few drivers, both longer-term and more recent, for that performance include:

- India's growing economy and rising income levels driving a growing middle class
- A high level of digitalization in the economy
- Growing government support for infrastructure (see pictures below), manufacturing, and exports that are enabling further investments by local firms and multinational corporates
- Desires by those same multinationals to diversify their supply chains away from China
- The quality of Indian management teams/founders often comparing favorably with their global corporate peers

The positives in India are well known, judging by the consistently lofty valuations ascribed to Indian equity markets.



The Mumbai Coastal Road Project continues along with other infrastructure improvements – already saving significant commute time and relieving congestion.

What is the biggest risk to Indian equity markets?

So naturally, given the rosy outlook and higher near-term valuations, one recurring question we asked the India-focused managers we met – **what can go wrong**?

There were a few common responses. While everyone acknowledges market valuations are high, they also recognize that valuations may not come down any time soon. In fact, Indian equities have remained more highly valued than most international markets for many years and the positive drivers noted above look less likely to change that. Others cite politics as a potential detractor – Modi won a far less decisive victory than expected, but by most accounts he will remain in charge and continue to push for popular business-oriented reforms. No one can forget the many disruptive, though often necessary, reforms that India has implemented, which have caused significant market volatility at points: de-monetization, non-bank financial reforms, RERA, GST implementation. But those in retrospect often short-term market disruptions yielded long-term economic gain. So what else worries investment managers today?

While no one is sounding alarm bells, there is a growing wariness among managers regarding the Indian retail investor. While everyone extols the benefits of the Indian consumer growth story, many of these same consumers are buying lots of Indian equities for the first time. Managers note that foreign flows into Indian equities, once a significant driver of market movements, have been flat to negative over recent quarters. Domestic inflows, often through Indian mutual funds and SIPs (systematic investment plans, essentially retirement plans) have picked up the slack and pushed markets higher. Further, local investment managers have shared anecdotes of retail investor flows into speculative small and mid-caps, mentions of banks being concerned that their new loans may be going straight into brokerage accounts to buy equities, and lingering concerns that an entire new generation of retail equity investors in India has never seen a market downturn.

This relatively technical concern regarding retail flows and investor sentiment has a counterargument though. What if foreign capital flows into India pick up again? Several managers noted that global and other emerging market focused funds have been on the sidelines, waiting for a pullback in Indian markets that has yet to come.

Final Thoughts

There are pros and cons to investing in anything, whether an asset class, a region, a country, or a specific company. With India, those pros and cons often get exaggerated at extremes. Remember, India is still an emerging market. While the longer-term fundamentals of the economy and market matter, global politics, interest rates, and foreign currency movements can matter even more over shorter periods. We draw comfort from the depth of work of our on-the-ground managers in these types of markets and continue to be mindful of their and our clients' overall exposure to any single area.

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