# Investment Opportunity in India

Dr. Vinay Nair
CEO and Chief Investment Officer, Ada Investments

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Ada Investments
152 W. 57th St, 20th Floor
New York, NY 10019
(212) 259-4400

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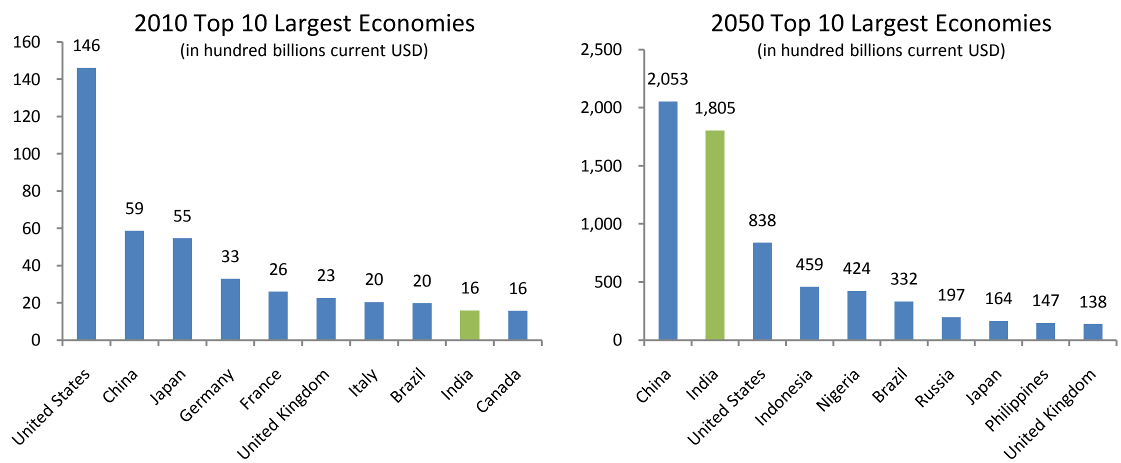
## Section One

# Why India?

India's economy, at about $2 trillion, is significant. In the coming decade it is likely to outpace that of several G-6 countries. Almost all projections place India in the top 5 countries within a generation. Longer term forecasts that take into account demographic trends place India in an even more favorable light. By 2050, India - with US and China - is expected to form the top 3 economies, and Russia, Brazil, Mexico, Indonesia, Japan, UK, and Germany are expected to form a cohort of comparably sized second tier economies.




*Source: Citigroup (Feb 2011)*

Underlying these projections are two powerful long term trends. Despite being a $2 trillion economy, the GDP per capita remains low at around $4000 in purchasing power parity (PPP) terms. That is roughly half of China's, one third of Brazil's and one tenth of the developed world's GDP per capita. This leaves plenty of room for growth. The fact that close to half the population is below 30 has been another oft cited statistic – and one that gives India a unique advantage over many other growing and almost all developed countries.

In the uncertain global economy we are in now, many such forecasts can easily be derailed by a country's reliance on export led growth. India is less susceptible to this fate since exports comprise less than one fifth of its GDP. This makes it less susceptible to a slowdown in Europe or China as well as any possible currency wars. A global slowdown also alters commodity prices that can often make forecasts look awry, as they did for Brazil and Russia in 2008. Since India is not a big producer of commodities, the country is less exposed to a slowdown in global growth on this account as well. Of course there are additional risks and any forecast should be digested with the prescribed caveats. Some that are in vogue are corruption, poor regulation and political incompetence.

While there is merit to these concerns – although those who don't grasp the changing dynamics between state governments and the national governments tend to be more concerned – we don't consider these to be significant in the context of the longer term picture. Yes, they may slow growth for a period, but the numbers still look formidable. In fact, during 1981 to 1988, when India was still mired in the bureaucracy and inefficiency of what today is termed as "license raj", the growth rate was 4.8%. It was only in 1991 that the regulatory changes and liberalizations ushered in an era of high growth. India has always been a country with these issues. These are not new, and the growth has happened in spite of these concerns. But more importantly, like most intensely democratic and developing countries, India is slowly putting its governance structures and institutions in place, making mistakes and learning along the way. This broader theme has been at play for a while, including during the global expansion of the 2002-2007.

These concerns may slow down growth, but the relative contribution of India's economy to the global GDP will still be significant. We think that any investor's portfolio – especially those that value diversification – should also reflect India's growing contribution to the global GDP.

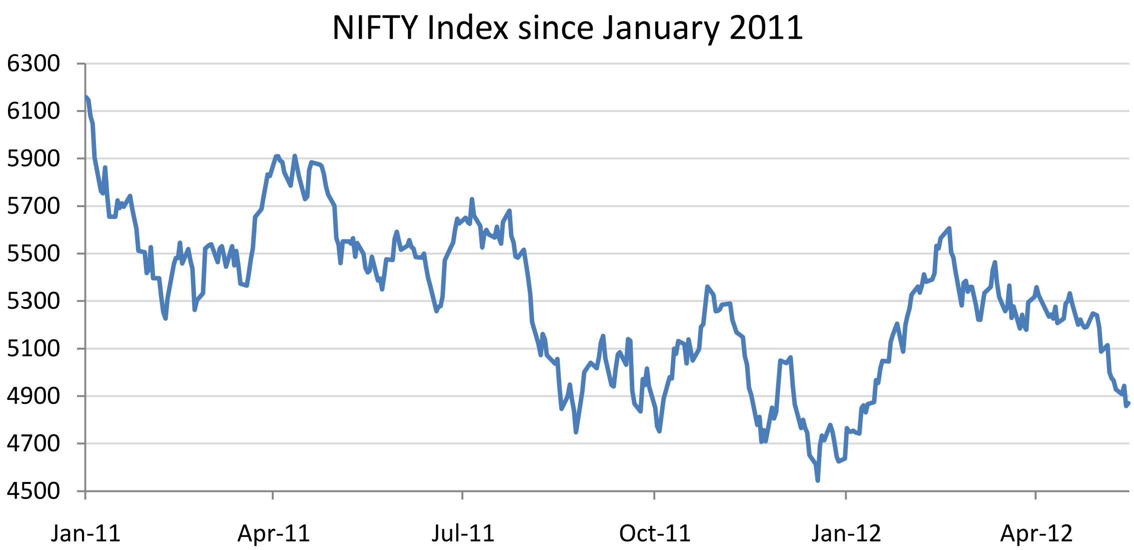
### Section Two

## Growth and Equity Prices – A Disconnect?

In spite of the impressive GDP growth, performance in equity markets has been lackluster over the past three years. Many market participants are trying to understand the dynamics here.

The crucial aspect is that equity prices are the result of both cash flows and capital flows. An overall argument towards continued growth supports attractive cash flows. But these cash flows get priced based on liquidity and capital flowing into the market. What makes Indian markets interesting is that they are heavily influenced by non-domestic flows. So any concern in the international markets can generate capital outflows and hurt equity valuations in India. Financial research has shown us that in the short run, variations in capital flows dictate equity returns, but in the long run, cash flows dictate equity returns.

This dynamic has two implications. First, medium term volatility in the equity market will be very high even if domestic growth is stable and attractive. To give you a sense of the volatility, India has been in either the top 5 or bottom 5 equity indices among global equity indices in each of the last 3 years. So compounding might be a challenge and behavioral triggers to flee are more likely to cause deviations from what an investor should be doing. Second, this provides an interesting opportunity to time entry into these markets. For a long term investor who strives to get a balanced allocation to growth markets, breaking down their target allocation into smaller packets and entering when valuations are low due to capital flows is an interesting option. For example, an investor who entered in January 2007 underperformed by over 50% relative to an investor who entered in January 2009. With this background, how should an investor enter India?




*Source: Bloomberg LP*

### Section Three

## Issues facing an investor that wants exposure to India

An investor who wants to participate in India's economic growth can do so by buying the aggregate stock index through an ETF or a mutual fund. There are at least three problems with this approach.

First, these instruments have done poorly in capturing the index returns. In fact, the tracking error for most India ETFs is in the range of 8-10% annually. For example, if you had invested in Powershares India ETF (one of the more popular India ETFs) in the beginning of January 2009, you would have made around 42%. NIFTY – the underlying benchmark index of stocks – was in fact up around 72%!

Second, most of these instruments target the large firms in India. These large firms are increasingly acquiring assets internationally. Slowly but surely, they are becoming multinational firms. In fact, Tata Motors derives a majority of its revenues now from its purchase of Land Rover and Jaguar a few years ago. Investing in many of the available indices essentially provides the investor an exposure to international growth through Indian multinationals. To be sure, there are mid cap indices, but the tracking error problems discussed earlier are worse.

Third, any long term investor should be keenly aware of the power of compounding. In an environment that is risk-on one day and risk-off another, compounding is even more important. Remember that 50% down one year and 50% up another still leaves you down 25%, but 20% down and 20% up next year leaves you only 4% in the red. Volatility is the enemy of compounding. So an investment that can provide controlled exposure to India will outperform a naked volatile exposure over the long term. This is more important in the Indian context since there are significant international flows in Indian capital markets making the markets sensitive to international investor concerns and generating volatility that is independent of the domestic economy.

Additionally in an uncertain world, if an investor faces a shock in their portfolio and has to adjust other holdings, it is more important than ever to control draw downs so that an unplanned and untimely exit does not become too expensive.

With these in mind, Ada's India Alternatives fund provides investors a hedged and controlled exposure to a large number of Indian stocks. The volatility of the fund is around 1/3rd of the overall market and provides for better compounding of returns.

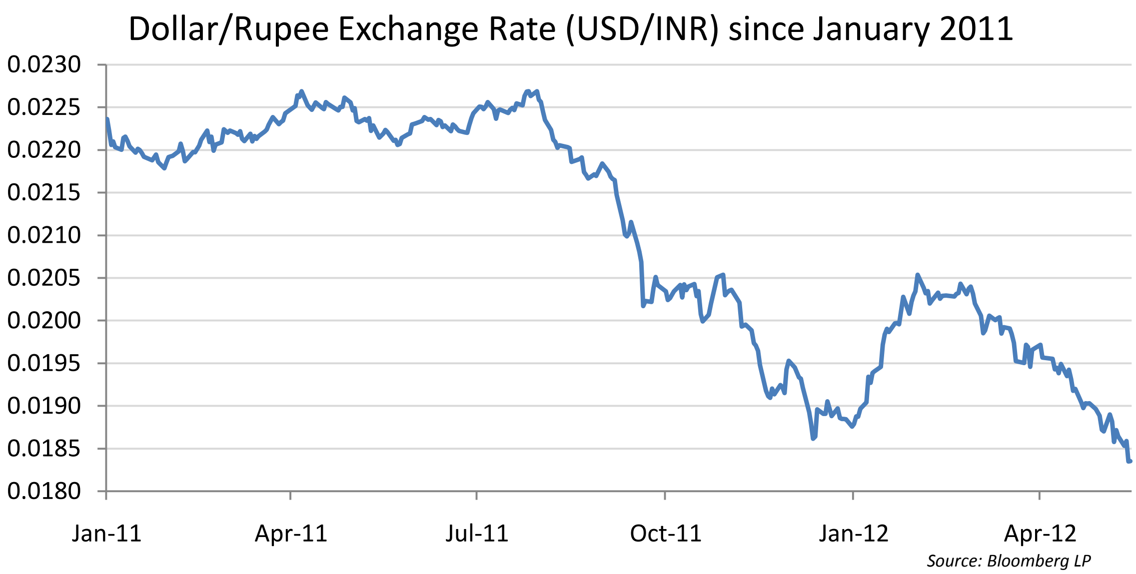
### Section Four

## Alpha

In addition to the controlled exposure to Indian equity markets, our fund also captures significant returns due to superior stock picking. Since financial markets are less developed in India, there is more "alpha" to extract here. The investment management industry in India is still in its early stages when compared to the developed world. Additionally, there are very few funds applying a rule-based approach to a wide array of Indian stocks. And among the ones that do, there are even fewer who have teams based in India. Local teams provide a better way to generate India-specific ideas. They are also better suited for a whole host of practical reasons to monitor risk and to detect any unusual rumblings among market participants. They also play a critical role in helping us develop local data platforms. With all these advantages, we are equipped to extract the higher alpha that exists in these markets. Using rules that are based on a whole host of different fundamental and ownership level information, we pick a diversified basket of over 60 stocks on the long side and over 30 stocks on the short side.

### Section Five

## Currency Risk




Any India skeptic will point the weakening rupee (INR) as a concern. We think this is an important and serious concern. Losses in the rupee will likely exaggerate any losses in the rupee portfolio. The currency is thus a source of additional volatility. Understanding the source of this currency volatility is important. There are three main aspects – the carry trade, the politics and the impact of oil prices.

Many currencies move together even while their economies don't because of the currency carry trade. In such a trade, carry traders buy currencies such as the Thai Baht, the Philippine Peso, South African Rand, the Brazilian Real, the Kiwi Dollar, the Aussie Dollar, and the Indian Rupee and short the Japanese Yen or the US Dollar. Any unwind in this trade creates weakening across all the carry trade currencies as we have seen this year. When funding costs go up for carry trades, the rupee, along with other carry trade currencies, weakens and when funding costs reduce, such as when QE1 and QE2 were initiated, the currency strengthens. These trends create their own momentum and turn with shifts in global liquidity.

In addition, higher local interest rates make carry trades more attractive. When India was aggressively strengthening interest rates in the last two years, it was also providing support to its currency by making it more attractive to carry traders. Now with the potential weakening of the interest rates, the unwinding effect is also likely to gain traction. If this coincides with another global liquidity shock, the rupee can fall much further.

Any dramatic fall in the currency – let's call it a "crash" – is what carry traders are compensated for. The return that carry traders generate is often thought of as the reward for holding this crash risk, and is exemplified by a saying in the carry trade world: "the trade goes up by the stairs and comes down by the elevator".

We are concerned about this risk. In 1991 when Indian deficits were high and over 12% of GDP, the Gulf war precipitated an oil shock and a currency crisis in India. The rupee saw significant and rapid depreciation of over 25% in 3 days. Today, things look similar – but significantly less dire - with a deficit of around 5% of GDP and a possibility of an oil shock due to the Iran-Israel situation. Importantly foreign exchange reserves today are over $300bn (In 1991 it was around $1bn!). That noted, a geopolitical shock or a funding shock in the global carry trade can still significantly weaken the rupee.

The other aspect that keeps pressure on the rupee is largely political. Subsidies provided to garner votes add a significant burden to the budget deficit. Additionally, coalition politics has blocked some foreign investment from entering India and thus reducing support for the rupee. Any change in these two aspects can only happen when the balance of power in the national government shifts, which most market participants don't expect till the next election in 2014.

Many long term investors automatically account for 4% annual cost in currency terms when investing in India. This thumb rule arises from the fact that since the government has allowed the currency to trade, it has weakened over 100% in the last 25 years or so – around a rate of 4% per annum. This is also roughly the interest rate differential between local interest rates and a weighted global interest rate. But with increasing volatility in the currency, the impact of currency movements is sometimes -14% (like it was last year) and sometimes (+20%) like it was in 2009.

Since April 2012, we have chosen to protect our investors from the downside scenarios due to an oil shock or an unrelated unanticipated event by buying an out of the money put option on the rupee versus the dollar. Our approach to managing currency risk keeps the hedging costs within a manageable range, and limits the downside due to the currency, while still allowing for the investor to participate in any possible upside. Such an upside scenario will emerge if capital flows enter India over the coming years (as we expect) or if some of the political deadlocks are addressed.

| Currency P&L at Different INR/USD Levels | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **June Month End** | **46.5** | **49.0** | **51.5** | **54.0** | **56.5** | **59.0** | **61.5** | **64.0** | **66.5** |
| P&L on Options | -4.9% | -4.1% | -2.8% | -0.8% | 1.8% | 4.7% | 7.8% | 10.9% | 13.9% |
| Currency P&L | 14.4% | 8.6% | 3.3% | -1.5% | -5.8% | -9.8% | -13.5% | -16.9% | -20.0% |
| **Total Currency P&L** | **9.6%** | **4.5%** | **0.6%** | **-2.3%** | **-4.1%** | **-5.2%** | **-5.7%** | **-6.0%** | **-6.1%** |

### Section Six

## Opportunity

Given the recent drop in currency and given our hedge, we think it is an interesting time for an international investor to invest. Additionally, the valuations in Indian markets are close to its 2008 and early 2009 lows. Taken together, the current environment provides the long term investor an ideal opportunity to enter a hedged India product. Such an investment today is perhaps contrarian. But evidence suggests that entering emerging markets when everyone else is entering, such as in 2007, is more risky than when they are out of favor, as they were in 2009. Our fund provides investors a vehicle to benefit from both the growth as well as the inefficiency in the Indian markets with rigorous risk management to control volatility and currency risk and investor support through accounting and return statements that are world-class.