



# HOW SPICY IS YOUR PORTFOLIO?

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# THE CASE FOR INDIAN EQUITIES IN A PORTFOLIO

Equities play the role of creating wealth in an investment portfolio. In the current environment, investors are concerned not only about valuations of major equity markets, but also the underlying growth of corporate earnings. How long can investors benefit from share-buybacks, cost cutting and productivity gains, without top-line revenue growth?

In this context, investors should be re-examining the role of equities as a growth component of their portfolio. Going ahead, it will be increasingly crucial to seek exposure to companies growing their earnings, whilst building a diversified portfolio. In today's challenging environment we highlight the need for differentiated portfolio construction to successfully navigate this.

- Avoid short term monitoring of investment portfolios which results in a focus on volatility, ultimately leading to poor long-term investment achievement
- Income strategies do not equate to safety. These strategies can still lead to capital losses and an opportunity cost of lack of growth in a portfolio. Growth strategies can provide diversification and should be assessed in this light rather than in a stand-alone fashion
- Diversification is becoming harder to find. Truly diversified strategies should have logical reasons for their differentiated returns rather than only looking at historical price correlations which can break down during market duress

When it comes to investing for growth, many investors have tried to fit a square peg into a round hole by equating "Emerging markets" (EM) as a proxy for exposure to high growth economies, which in their expectations should result in higher returns. In our view, this naive approach fails for the following reasons:

1. Research illustrates that high GDP growth doesn't always equate to high equity returns<sup>1</sup>
2. EM are an eclectic group of countries grouped together to form an Index (MSCI Emerging Markets). These countries share little in common apart from not being classed as Developed
3. The term EM embraces countries that are big and small, developed and under-developed, industrialised and agrarian, manufacturing and commodity-based and in deficit and surplus
4. Over 20% of the countries in the EM Index are growing slower than the US!

Hence, it pays to be selective when identifying growth opportunities for a portfolio. An allocation towards developing economies such as India's is likely to provide a dual benefit of long term capital growth and diversification to high yielding strategies such as Australian/NZ Equities, REIT's and Fixed Income, which are plentiful in investor portfolios today.

So why India? We reiterate several reasons why Indian equities are an attractive investment destination for investors. These include;

- Robust, world leading GDP growth, driven by its youthful demographics, urbanisation and economic reforms
- Strong and sustainable earnings growth from rapidly growing top line revenues
- Low correlation with NZ and Australian Equities at 0.3.
- Complementary sector exposure for NZ investors invested significantly in their "home" equity market, through significant Consumption, Healthcare and Information Technology industries in India

<sup>1</sup>Dimson, Marsh and Staunton, Credit Suisse Global Investment Returns Yearbook 2014 London Business School and Credit Suisse



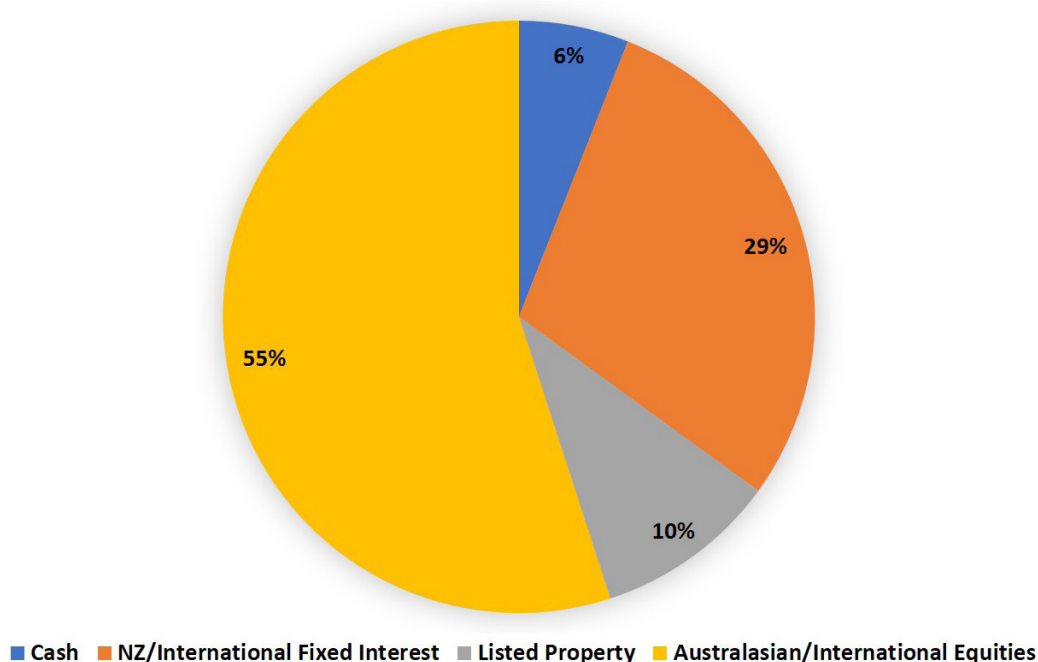
Leading practitioners continue to overhaul their approach to portfolio construction by adopting new frameworks, tools and techniques to deliver a customised approach attuned to their client objectives. Their rationale for changing their philosophy has been due to the following issues with the traditional approach.

- Strategic asset allocation (SAA) has its flaws: One major draw-back of the traditional approach is that it groups assets into “buckets” which reduce the portfolio’s flexibility and limit its diversity. Investors can often neglect new strategies, despite being fundamentally sound and additive from a portfolio perspective, until they become more “mainstream”. Risk for many is perhaps defined as not being mainstream!
- Achieving portfolio objectives is what ultimately matters: Whilst it is important to do as much homework as possible on each investment, it is paramount to adopt a total portfolio approach to achieving objectives. Managing each asset class to an arbitrary index, rankings or peer group, whilst also maintaining the portfolio’s objectives can be conflicting
- Is volatility the appropriate measure of risk: The definition of risk for many investors, remains solely the volatility of the price of an asset. As Warren Buffett once noted, using volatility as a measure of risk means that “an asset that has dropped very sharply compared to the market becomes “riskier” at the lower price paid than it was at the higher price”. This is clearly a flawed proposition. In our view, volatility is a proxy for fear which often leads to irrational investor behaviour

Looking beyond the traditional approach enables a more positive investment thesis for asset classes like Indian equities. It is our view that Indian equities can play a role as a long-term asset with the intention of delivering capital growth to an investor’s portfolio.

So how much should an investor consider allocating to Indian equities in their portfolio? Looking at a typical NZ portfolio below, for a typical balanced fund, allocations to India are at most 0.5% to the fastest growing major economy – purely due to an obsession with “bucketing” and index following.

### Typical Asset Allocation of a NZ Balanced Growth Fund





Based on generalised levels of risk aversion, amount of growth needed and diversification, our analysis suggests that the allocations below are worth considering. For further information on the quantitative aspects considered in this analysis feel free to reach out to us.

PHASE	AGE BRACKET	ALLOCATION	RATIONALE
Buying assets	18-30	5-10%	Risk aversion is low, but the need for short-term wealth to buy assets maybe high with some investors.
Wealth accumulators	31-55	8-10%	The longest time horizon of the phases, combined with lower risk aversion, means the appetite for an exposure to Indian equities is higher
Pre-Retirees	56-65	4-6%	Whilst risk aversion levels and sequencing risk increases, super contributions allow them to take a dollar cost averaging approach in a disciplined manner, where market volatility can be evened out and still grow their balances
Retirees	66 +	2-4%	Despite higher levels of aversion to risk, longevity risk means that growth is still required

Many NZ investors have a hurdle above inflation. We have modelled the optimal allocation based on the expected levels of inflation going forward, amount of growth needed to achieve a premium to inflation and levels of diversification.

OBJECTIVE	ALLOCATION	RATIONALE
CPI + 3-5%	5-10%	Apart from inflation linked bonds and to some extent Real Estate/Gold, inflation is difficult to hedge. Therefore, to achieve a rate above inflation, certain levels of capital growth is required. As mentioned, Indian equities is a capital growth story rather than a dividend yield play

Whilst conventional wisdom would state that an allocation to equities, particularly Indian equities, for a retiree's portfolio would be absurd, it is our view that it is one way that we can counteract longevity risk, given capital growth is indeed a scarce commodity in global investment markets today. This asset-liability conundrum requires allocation to long term investment themes as a component in portfolios.

Most investors/funds are lowering their investment expectations and simply accepting low future returns from conventional assets, rather than scouring the globe for assets that provide capital growth. An allocation to the world's fastest major economy with several exciting companies on offer could be a crucial addition in a portfolio.

**Visit: [www.IndiaAvenueInvest.com](http://www.IndiaAvenueInvest.com)**  
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