



Market Maven

World shopping

Ajay Srinivasan weighs the risk-reward of global markets to conclude: India is great

Nikhil Walavalkar

After a sustained bull run across global equities for seven consecutive years, world markets seem to be retreating finally. Considering that Indian investors now have the option of investing abroad, we posed the question on how to approach the world market from an Indian investor's perspective to Ajay Srinivasan. Excerpts:

What is your outlook on equity markets across the world, particularly emerging markets and India?

If I look at the overall equity market there is still a reasonable amount of uncertainty. At this moment we are cautious on equity markets around the world. I think, going forward, if earnings growth rate holds up, equities will only become more attractive as valuations have come down.

Globally, I think emerging markets will continue their outperformance for the eighth consecutive year. There are multiple reasons. First and foremost, valuations are reasonable. We think, given the correction, emerging markets look reasonably priced. Second, the earning resilience shown by these markets.

Emerging markets' earnings are less susceptible to downside in the broader sense. I think there are good growth prospects though these economies will surely be somewhat impacted by the US slowdown, especially export-oriented economies and their equity markets. The last factor is the macro fundamentals such as strong GDP growth and the domestic consumption theme that supports emerging markets. Add to this the fact that emerging markets are not as leveraged as the US, the picture only looks brighter.

We also think emerging markets will be the beneficiary of cheap



PHOTOS: SANJIT KUNDU



money which is being pumped by central banks around the world. We think that the first six months of the year could be a bit of a challenge but as the US starts recovering, we think, from June/July onwards, the liquidity will be back in emerging markets.

As we can see, India has borne the brunt of risk aversion. As people turned wary of taking risks, they cut their India exposure. But I think given that FIIs hold 43 per cent of the market free-float in India, near-term performance is going to be driven by global factors, whether you like it or not. The other factor will be the relative valuation of our markets versus others. India is much cheaper than it used to be, but it is still not cheaper relative to other markets that FIIs look at.

The second factor specific to India is that while the softer global economy, inflation and elections play a key role, I think, on the flip side, the stimulus to consumption specially from the last Budget will start kicking in from the second half of this year. So this is the time to look at fundamental bottom-up stock picking against the broad momentum-based themes.

Now that Indians are allowed to invest in global markets, do you think it is an option they must exercise?

The answer to this question lies in the perception of risk-adjusted return. Risk-adjusted returns are a function of differential returns between the markets adjusted for currency and other risks. Let me share with you the experience at least in three other markets that have opened up recently - Korea, Malaysia and China, wherein off-shore investing was allowed in the past decade. If you look at both Korea and Malaysia today, about 25 per cent to 30 per cent of the total mutual fund assets are in schemes that are off-shore. Korea is slightly less than Malaysia. China is very much like India where investment outside China has actually not picked-up in a big way. I think to understand the reason behind this one must go back to either the Korean or Malaysian example.

Take Korea. In the initial phase the domestic market was strong, so the Koreans did not think of investing outside the country.

But subsequently these economies, particularly, Korea went through a period of consolidation and we saw increased investor interest in markets

outside Korea. China and India were two beneficiaries of this movement of capital. The won started depreciating, so did the ringitt. However, the minute both the currencies started appreciating people pulled back because they found a large part of their returns eaten up. So we actually saw a large period of lull, followed by a sudden increase in investment and then a slowdown again. Now China is going through the same phase. Chinese investing outside the country has not picked up because they find home markets still attractive.

If one were to consider other markets for the sake of diversification, what would you recommend?

When you are looking to diversify you have to look at two factors. First, look at the correlation between the markets. If the market is highly correlated to the one that you have already invested into, then you won't get the benefit of diversification.

The second factor is the attractiveness of the market itself. At the end of the day, if you are investing in a market that is not going anywhere but it is negatively correlated to India then you may not necessarily gain anything by investing in that market. So you got to look at both these things. Keeping these two factors in mind, there are three interesting markets at this point in time.

Within Asia, Taiwan is interesting given the recent elections, plus the country's focus on high-end technology, which has been an underperforming sector for a long time now. On the flip side, though, is the Taiwanese dependence on exports. In Asia, Korea is the other interesting market. In Latin America, I personally like Brazil and Mexico and I think both of these

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are big beneficiaries of what is happening around the world.

Sobroadlythesearethreemarketsthat look interesting from a diversification point of view, but then Indians do not have that much access to these markets today.

When global liquidity is driving equity markets, does international equity investing offer true geo-political diversification?

The correlation between markets is really interesting. If you look at the highs of the markets around the world

Ajay Srinivasan

AGE: 44

EDUCATION: Ajay holds a BA with Honours in Economics from St Stephens College, University of Delhi and an MBA from the Indian Institute of Management, Ahmedabad.

CAREER:

1987: Srinivasan was hired by ICICI while still a student at the Indian Institute of Management, Ahmedabad. He spent four years at ICICI, primarily in project appraisal, before moving to ITC. He managed ITC's in-house funds for a while before he got his first big break setting up ITC's brokerage business.

1998: Joined Prudential as managing director of Pru-ICICI, Prudential's Indian fund management joint venture with ICICI Bank. As a member of Prudential Corporation Asia's board, Ajay also oversaw the development of Prudential's retirement business in Asia.

2007: In July 2007, he was appointed as chief executive, financial services and director, corporate strategy and business development at the Aditya Birla Group. In his role as chief executive, financial services, he sets the strategic direction for the group's financial services business

since October 2007, the MSCI World index lost about 15 per cent and the MSCI Emerging Market index lost about 17 per cent and the weekly correlation stood at 0.83, which indicates a fair high degree of correlation.

Basically, markets are very broad and have been moving similarly so far and, therefore, financial de-coupling is actually not happening. I think that's the first point and, therefore, diversification at least on the broad categories doesn't seem to have happened. But there are individual markets where you could find a fair amount of difference.

For instance, there is increased correlation between India and Hong kong over the last three years. The correlation with China over this period reduced and now we have almost no correlation with the Chinese markets. So for Indian investors, China may be a good place to look at just from a correlation point of view.

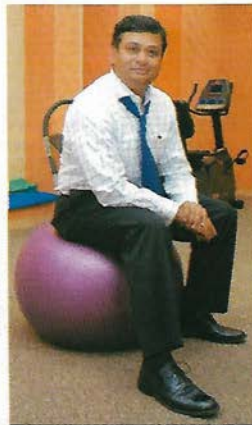
But while de-coupling in financial market is not happening, I think eco-



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MAKING SENSE:
Ajay Srinivasan believes that emerging markets will be the beneficiary of liquidity as soon as the US starts to settle down



economic de-coupling is slowly happening. The emerging markets may face headwinds from slower external sector but because of domestic consumption and infrastructure needs, these economies are slowly beginning to de-couple. When that happens, you start seeing earnings de-couple and that, in turn, will lead to de-coupling of financial markets, though I have to say this has not been the case so far.

What is your expectation on the currency front? And keeping the currency consideration in mind, how do you expect returns to pan out?

After appreciating most of fiscal 2008, the rupee has obviously weakened in the last couple of months but we think there is a high probability that the rupee will keep appreciating against the dollar owing to rising foreign institutional inflows. Inflows are expected to resume towards the second half of this year.

Second, the high interest rate differential against the dollar will again buoy inflows as we don't see interest rate necessarily coming down in India, while in the US rates have already seen a significant cut.

On the flip side, the budget deficit is going up along with rising crude which makes a case for letting the ru-

At this point, given the uncertainties in financial markets, I wouldn't take a bet based on currency views alone

Will you subscribe to the view that developed equity markets are less risky than their emerging counterparts?

Definitely. Developed equity markets are less riskier compared with emerging markets. At the end of the day you want risk and returns to go together! Emerging markets are attractive and people expect greater returns because there is greater risk. This has borne out in the past too as these markets have delivered much better returns. I do think emerging markets will be the beneficiary of liquidity as soon as the US starts to settle down. As investors turn confident and sentiment improves, the sea of liquidity will look for places that offer good returns. Money will, thus, move to emerging markets as long as valuations are attractive.

What is the track record of mutual funds in other markets? In India there still seems to be a lot of imperfections in the market which means active funds can continue to beat the

benchmark indices for a while....

In Asian markets, ex-Japan, the track record of the active fund managers in beating the benchmark has been very good. But it is important to understand where this alpha is coming from? The alpha comes from broadly three sources; one, from the efficiency of the market and that is why, typically in the developed markets it is tougher to beat the markets. The second source is the fund manager's expertise and I would expect that fund managers across the world are probably as good as each other so that should not necessarily be a factor. But the third factor, that is important in my view, is the fund objective and stated benchmark.

Between 2004 and 2006, in the Indian market, several funds beat the market benchmark by a reasonable margin because they had exposure to mid- and small-caps which were not part of the index. If you are invested outside the index and if that sector does well you will automatically do well.

Subsequently, when large-caps started moving, funds found it difficult to beat the benchmark because they were working in a very different universe. Again to give an example from the region if you take Malaysian markets, for instance, there are three stocks that account for about 60 per cent of the total market cap of the benchmark index.

So if you have the right view on these three stocks then you can beat the benchmark easily. Beating benchmarks often has to do with the construction of the index and the objective of the fund that you create.

Keeping this in mind, looking for active fund managers with a long track record is a best way to start investing in most emerging markets. But if you are going to enter more developed markets like the US market, then buying an ETF (exchange traded fund) or buying anything that tracks the broad markets is probably a good way to proceed.

Post sub-prime do you think debt funds overseas could be a good hunting ground?

There are broadly three factors to look at - risk-free rate, credit spread and currency risk as far as debt fund investments are concerned.

Looking at the expectations of continued differentials in interest rates in favour of India and the outlook on the rupee, we don't generally see the risk-reward favouring overseas debt at this point. □