When discussing portfolio construction with Indian investors, one question that frequently comes up is whether it makes sense for an Indian investor to invest outside of India. Indian equity markets have compounded capital at high double digit rates over the past thirty plus years and with the Indian economy expected to grow at the fastest pace of the large economies globally, investors continue to expect great returns from the Indian equity markets. Why then invest outside India?

For one thing, the idea that equity market returns are equivalent to GDP growth rate is an incorrect one. Baijnath provided a detailed discussion on this topic in his article, Stock Market Returns – The GDP Growth Rate Myth [1]. More importantly, an Indian investor derives significant diversification benefits by allocating to global markets; a topic that we will delve into in this article.

Investment Returns: Adding Global Allocation Results in a Slight Enhancement

Most market participants in India use the start year as 1979 when talking about investment returns of Indian equity markets. Between 1979 and 2017, i.e., a period spanning nearly 38 years, the Indian equity markets have generated a compounded annual return of 15.5%. Clearly, this is a very high rate of return. This is especially true when one compares this number to the long-term investment return from US equities [2] of approximately 9%.

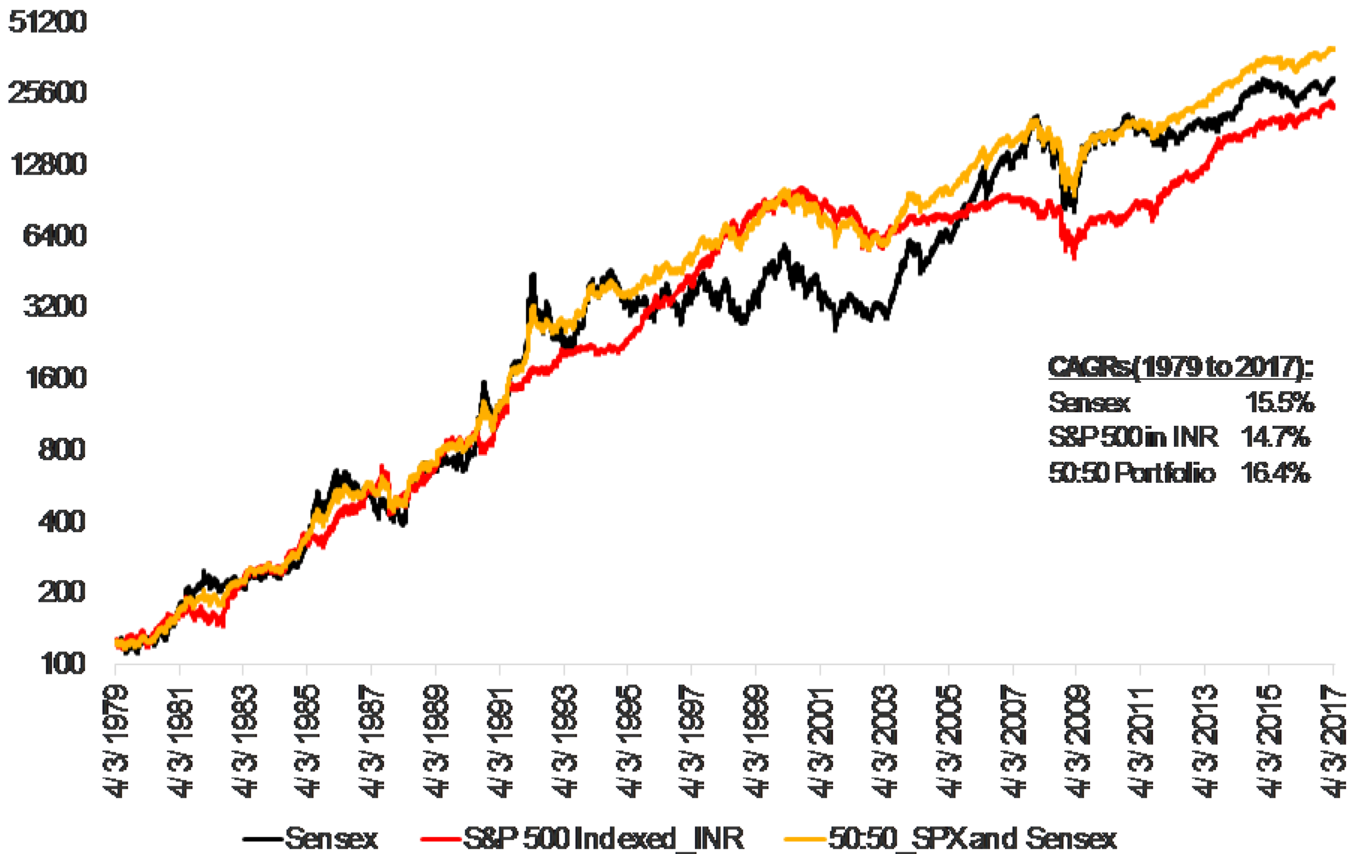
However, it is important to note that the time periods involved in the estimation of both these returns, i.e., 15.5% long-term return for Indian equities and 9% long-term return for US equities are not the same. Indeed, if one were to use the same time frame for both the returns, i.e., 1979 to 2017 and calculate the returns in the same currency, in this case in INR terms, the returns turn out to have been remarkably similar. Over the past 38 years, i.e., between 1979 and 2017, the S&P 500 returns when calculated in INR terms were 14.7%.

It is important to note here that it is indeed the INR returns that are relevant to an Indian investor as the investor will also realize the change in currency's price.

In the chart below, we have plotted the Sensex along with the indexed values of the S&P 500 in INR terms and a portfolio that was equally split between the Sensex and the S&P 500 [3]. As is seen, the Sensex and S&P 500 returns are both rather similar. Interestingly, combining the

© 2019 MULTI-ACT.

two resulted in a slightly higher return.



Post-Liberalization Returns

As discussed in Stock Market Returns – The GDP Growth Rate Myth, "*In 1991, India started with its economic liberalization policies that seemingly lifted it above its derogatorily termed "Hindu rates of growth* [4]*. With the hypothesis that equity market returns are largely driven by return on capital of all businesses, what should one have expected to see in terms of equity market returns, once the economy opened up? Most people are quick to say that equity market returns should have improved as economic performance improved. However, that's not supported by our hypothesis. Pre-liberalization, businesses that existed were likely earning returns well above cost of capital, as there were significant barriers to entry driven*

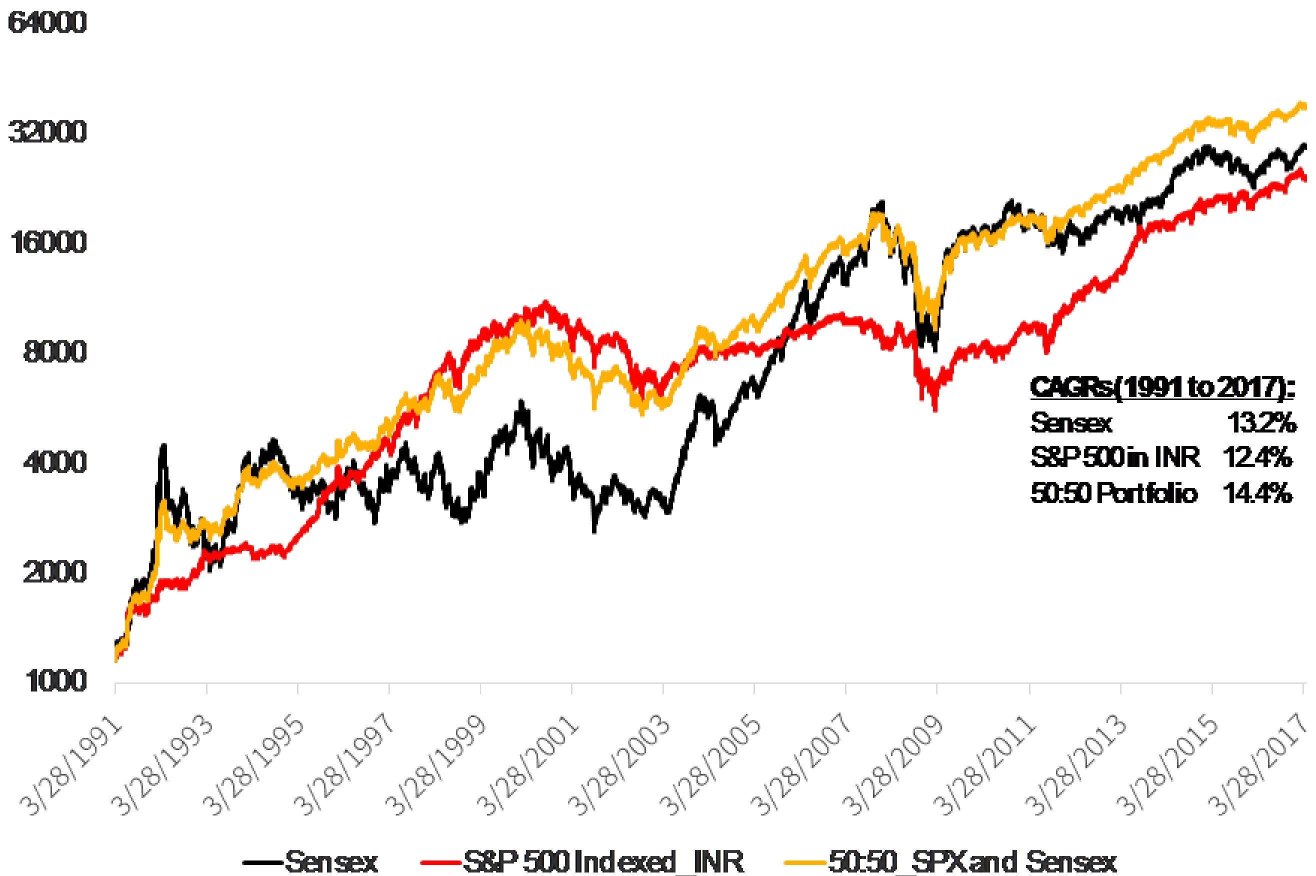
© 2019 MULTI-ACT.

by government policies and the license-raj system [5]*. However, as the economy started to open, it would have been logical to expect returns on capital to be driven lower since competition, both from local as well as international players, was about to increase.*

So what happened? In the pre-liberalization period, the Sensex grew at a CAGR of 26.0% from 1979 to 1991. However, in the post-liberalization world, the Sensex grew at a compounded annual rate of return of 11.8% from 1991 to 2015. Clearly, competition did exactly what it was supposed to do: reduce the economic production that is shared by providers of capital."

The reason why we are drawing your attention to the above is because we believe it is of utmost importance for an investor to have realistic expectations of investment returns. Given that the equity market returns between 1979 to 1991 were supernormal, we believe it is appropriate to look at the returns data since 1991. The chart below shows the Sensex along with the S&P 500 in INR and the 50:50 Portfolio since 1991.

© 2019 MULTI-ACT.



Once again, we see that the Sensex return is very much in the same zone as the numbers for the S&P 500 and combining the two portfolios resulted in a slightly higher return.

To summarize, we see that over a long holding period, adding global equities to an Indian equity portfolio does NOT result in a loss of returns. But then why go through the hassle of making an allocation outside of India if there is no significant benefit to doing so?

Investment Risk: Adding Global Allocation Matters When It Is Raining Hard

The table below summarizes the risk and return characteristics of the Sensex, the S&P 500 Index in INR, and a 50:50 Allocation Index over the two time period discussed earlier.

As you go through these statistics, notice the annualized standard deviation for the Sensex

© 2019 MULTI-ACT.

as against the other two indexes. Clearly, the Sensex is significantly more volatile that the S&P 500 index. Also notice the impact that a global equity allocation has on the portfolio's characteristics as is seen in the right most column. It is clear that making an allocation to global equity markets results in a superior investment portfolio with better sharpe ratio, significantly lower volatility, and reduced drawdowns.

	Sensex	**S&P 500 Indexed_INR**	**50:50_SPX and Sensex**	**Change over Sensex**
1979 - 2017				
CAGR	15.5%	14.7%	16.4%	**0.9%**
Max Drawdowns	**-61%**	-50%	**-52%**	**9%**
Annualized Standard Deviation	27.8%	15.7%	17.6%	**-10.2%**
Sharpe Ratio	0.34	0.56	0.59	**0.25**
1991 - 2017				
CAGR	13.2%	12.4%	14.4%	**1.1%**
Max Drawdowns	**-61%**	-50%	**-52%**	**9%**
Annualized Standard Deviation	28.2%	14.9%	18.0%	**-10.2%**
Sharpe Ratio	0.26	0.43	0.47	**0.21**

Perspective of a High Quality Investor: Expanding the Investment Universe

At Multi-Act EquiGlobe (MAEG), we specifically focus on a smaller sub-set of companies. These are businesses that in our opinion qualify as the best businesses to own across the globe. Such businesses are characterized by presence of durable competitive advantages; competitive advantages that are strong and wide. The strong competitive advantages possessed by the business results in significantly superior economic returns on capital both on the existing capital employed as well as on incremental capital investments. We call these businesses as High Quality (HQ) businesses.

We believe that a carefully constructed investment portfolio that is composed of truly HQ businesses results in superior investment returns while simultaneously lowering risks embedded in the portfolio. The superior returns at lower risk attributes are driven by the quality of businesses included in the portfolio with each one of these businesses enjoying high underlying returns on capital and possessing competitive advantages that allow them to

© 2019 MULTI-ACT.

withstand economic and industry slowdowns better than the rest.

Indeed, we are of the opinion that such an HQ investment strategy should serve as the core equity strategy of investment portfolios that are focused on capital preservation while enjoying superior “real” rates of investment return. In fact, this is also the primary reason why we believe that it is of utmost importance to an Indian investor to make a global allocation.

Expanding the Investment Universe to Improve the Quality of Businesses in the Portfolio

The primary issue in limiting oneself to India, more so from the point of view of an HQ investor, is that it means a significantly limited investment universe. Consider that at MAEG we scour for HQ businesses and yet our investment universe has just about 150 companies. Truth of the matter is that there really aren’t a lot of truly HQ businesses.

Given the fact that we have been able to identify only about 150 HQ businesses across the globe, Indian equities being a small sub-set of global equities, the investment universe becomes severely limited. Additionally, given that the sub-set of Indian HQ businesses is rather small, it ends up limiting the portfolio’s exposure to a handful of industries.

Conclusion

Including global equities within an Indian equity portfolio results in a reduction in the overall risk of the portfolio while maintaining a similar return profile. More importantly, an investor interested in constructing a portfolio of HQ businesses will find that sticking to an India only exposure results in significant compromises on the Business Quality spectrum.

Clearly, a rational investor will do well to introduce an appropriate global equity product within their overall equity portfolio. Doing so helps reduce the portfolio’s investment risks. More so, it allows the rational investor to construct a portfolio that is significantly superior in terms of the quality of businesses included in the portfolio.

© 2019 MULTI-ACT.

Notes:

Stock Market Returns – The GDP Growth Rate Myth, Baijnath Ramraika, April 2015. ↩
Note that in absence of data, we have used the S&P 500 as a proxy for global equities. ↩
The 50:50 portfolio was rebalanced at the end of every March, i.e., once a year. ↩
Hindu rates of growth refer to low growth rate of India's planned economy.
See: http://en.wikipedia.org/wiki/Hindu_rate_of_growth." ↩
The License Raj system refers to the system of licenses that were required to setup and run businesses in India in the pre-liberalization era. See: http://en.wikipedia.org/wiki/Licence_Raj. ↩

© 2019 MULTI-ACT.