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US funds go for growth in resurgent economy

By Khozem Merchant

The MassachusettsInstitute of Technology, one of the world's leading academic bodies, may have alumni spread across Indian industry but now it hopes to stamp a different footprint on the country.

MIT's $6bn endowment fund, the fifth largest university fund in the US, recently added India to its portfolio, joining a rising number of long-term US investors seizing opportunities in Asia's fastest growing economy after China.

The participation of MIT, as well as the recent entry into India of Calpers, the world's largest pension fund, and Cascade Investment, which manages the private wealth of Bill Gates, Microsoft chairman, coincides with a six-month bull run in the local stock market.

Martin Kelly, MIT's director of marketable securities who recently spent a week visiting Indian companies, says continuing economic and stock market reforms are allowing India to "benefit from its globally competitive advantages" and have boosted potential gains from Indian investments.

In the six months since the general election, which triggered mass selling of domestic securities, foreign investors have been returning to India. Since May, when net flows were a negative $806m, portfolio investments have been positive each month. Foreign institutional investors (FIIs) have pumped in $6bn this year, within reach of the record $6.5bn in 2003.

Much of this inflow has come from first-time investors, including US annuity funds such as MIT, as well as mature India funds raising their country allocation. This strong liquidity has driven up valuations, with the Bombay Stock Exchange Sensitive Index of top 30 shares last week closing above the 6,000 mark for only the second time.

The index has gained 33 per cent since hitting a low of 4, 505 on May 17, when the new Communist-supported government emerged. The market is trading at 12 times 2005 earnings, which fund managers say still represents value, although many observers are wondering whether a big correction might be on the cards.

"The speed of the revival has not been surprising. What is notable is that there haven't been any corrections along the way," says Jyotivardhan Jaipuria, head of research at DSP Merrill

Lynch in Mumbai. "We expect the index to reach a high of more than 6,250 in 2005."

Many foreign investors believe Indian fundamentals merit continued optimism. The economy is forecast to expand between 6 and 6.5 per cent after a weak monsoon, corporate earnings are up by a fifth from last year, manufacturing's turnround is firming up, and the growth of outsourcing is lifting IT companies.

This broad-based positive outlook has persuaded sceptical investors such as MIT. **"The arrival of these conservative US funds reflects the reality that India is part of the global asset stage — that was not the case two years ago," says Jon Thorn, who manages the $150m India Capital Fund in Hong Kong.**

Mr Kelly is similarly cautious. "We recognise valuations may be stretched and that there are other near-term risks," he says. These risks include rising interest rates and input costs that could trigger a cyclical decline in some sectors.

But another Hong Kong-based fund, managing $1bn of Indian assets, makes a more cautious interpretation of the confluence of a resurgent BSE index and the Congress-led government's early success. "Some issues have been healed but there are concerns about political stability — not for nothing is India seen as a market that moves independently of world markets," says this fund's manager.

Nonetheless, the presence of MIT, Calpers and Cascade suggests these investors believe there are longer-term gains to be had from Indian securities.

Annuity funds must not only earn returns to cover current operations, they must preserve and increase their funds to ensure returns are sufficient to pay their unit-holders' pensions.

"These new investors have no excuse to continue benchmarking emerging market exposure to conventional yardsticks. What they are saying [by selecting India] is 'we want to invest where there is growth'," Mr Thorn says.

One problem new investors face is a limited choice of quality stocks of scale. That universe has expanded this year with share offerings by Oil and Natural Gas Corporation, the biggest exploration company; National Thermal Power Company, which generates a fifth of India's power needs; and Tata Consultancy Services, the leading IT services company.

Each gives investors exposure to companies at the heart of the Indian growth story. But regulatory caps on foreign holdings in companies - shares of ICICI, a bank, and Grasim, which makes cement, are close to their ceiling — and the rapid rise in mid-cap stocks are forcing investors to look further field. Rising valuations could force FIIs, which already own 24 per cent of the BSE Sensex by capitalisation, to look lower down for disproportionate returns, says Mr Rajesh Jain, director of Pranav Securities in Mumbai.

This means FII interest could shift to mid-cap companies in sectors such as pharmaceuticals, chemicals and commodities, where size had previously made them unviable as investment targets. Foreign investors could be lured by medium-sized IPOs, such as those planned by UTV, a television producer, and Shoppers' Stop, a retailer — services that reflect the new spending power of young professional Indians.

Prime Database in Delhi, which tracks IPOs, says there are Rs550bn ($12bn) of new issues in the pipeline. That may put pressure on secondary market performance but it also opens another front for India's new investors.

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