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A Slow Start for Indian Stocks Shouldn't Faze Fund Managers

By Kimberly Song

The Stellar Gains in India's benchmark stock index last year have prompted some participants to wonder how much game the market has left in it.

It's an increasingly urgent question for fund managers, who, thanks to 2003's run-up, suddenly have a lot more of their client's money to invest in the country. Established Indian funds as well as dozens of newly created ones have received about $612 million so far this year in new money, according to figures by EmergingPortfoio.com Fund Research.

The first nine weeks of the year have disappointed. The Sensex, an index of the Bombay Stock Exchange's 30 biggest stocks, has fallen 0.4% since the beginning of 2004.

"Don't worry," says Jon Thorn, a Hong Kong-based fund manager with a decade of experience in the Indian market. Though he's definitely not expecting the Sensex to repeat last year's 73% gain, he remains optimistic that strong economic growth and other positives will make fund managers happy to stay in the game.

"For years, Indian stocks have been so beaten down," Mr. Thorn says. "Last year, we saw a massive re-rating of companies to where they should be trading. This year," he adds, "India is going through a textbook structural turnaround and that will carry the entire market." He recommends casting the net widely across an array of sectors in the burgeoning economy.

Mr. Thorn, whose fund returned 130% last year, is also getting swamped with new money. Since September, assets under management at his India Capital Fund, an offshore hedge fund, have surged to more than $115 million from $30 million. But Mr. Thorn feels he has more places than ever to invest it.

He notes that India is growing almost as quickly as China, Asia's other big economic juggernaut. India has an enviable demographic: More than half of its one billion people are under the age of 25. Since incomes are rising for many of them, and the country has low interest rates and has made favorable tax overhauls, domestic consumption is likely to take off, the fund manager asserts.

In addition, years of government-led restructuring efforts, which forced some of India's inefficient companies to clean up their balance sheets and become more globally competitive, are now translating into strong earnings growth across many sectors. The government is spearheading big infrastructure investments in roads, ports and telecommunications. Improved relations with Pakistan and expanding trade with China, he contends, will continue to buoy confidence.

Fundamental changes have made Mr. Thorn revise his long-held Indian investment strategy. Starting from the 1994 launch of his first fund, the Indian Smaller Companies Fund, with a $7 million investment from Soros Fund Management in New York, his strategy was to focus on small companies, many of which were in joint ventures with multinationals.

Despite low levels of liquidity, these companies offered more transparency, better management and superior products. Best of all, from his point of view, they weren't affiliated with the large conglomerates going through painful restructurings. Mr. Thorn used to pick just a handful of companies and would hold his positions for years. (He still remains an investor in some small companies such as Essel Propack, a toothpaste-tube manufacturer).

However, during 1999 Mr Thorn observed the beginnings of a trend he felt signaled India's economy was about to bear fruits of its restructuring. At India's large companies, free-cash flow, the amount of money a company has left after paying its expenses, was rising while debt obligations were shrinking. This led to a marked improvement in their balance sheets.

"The reason why we were in small caps was no longer valid," says Mr. Thorn, who soon changed his fund's name and re-registered it as a hedge fund, which allows him to take riskier positions. During May 2001, he launched the India Capital Fund with about $20 million in assets under management. As a hedge-fund manager, Mr. Thorn says he has the flexibility to invest in companies that have strong fundamentals as well as ones with good short-term opportunities. This he says, befits the India market's new increased transparency and liquidity.

Today, Mr. Thorn says his fund is more broadly invested than ever, holding stakes in 36 companies, up form about 20 for most of 2003. Instead of cherry-picking stocks, as before, he is investing across more sectors. India today has about 130 companies with market capitalizations greater than $500 million, spread across businesses from manufacturing to pharmaceuticals and technology.

Though valuations have risen during the past year, shares in India can still looks attractive. CLSA says the group of Indian companies it covers trade at a price-to-2004 estimated earnings ratio of 13.3 times, but less than its similarly calculated ratios for Malaysia (15.8 times) and Singapore (15.3 times).

More than half of Mr. Thorn's portfolio is in banking, metal and cement companies. But he holds stakes in auto, pharmaceuticals and media businesses. He says he likes banks purely as a play on gross-domestic-product growth. He holds five of them and says he has been recently adding to his positions.

His expectations of continued good GDP growth makes him like metals, as he expects regional demand to rise steadily. The price of base metals, declining for nearly two decades, is turning around. He holds four metal stocks.

Also as a GDP play, the fund manager owns three cement companies. He says: **"As the economy grows, there's going to be a lot more building going on in India."**