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Country Profile

India begins to break out

China has taken all the attention, but are investors missing a trick?

By Jane Parry

In recent years India's fledgling hedge funds industry has benefited from the growing interest of offshore managers, attracted by its large, liquid market.

London-based Boyer Allan set up its India Fund in October 2003 and now has $17.5 million in assets under management. Singapore-based Raj Mishra launched his Indea Absolute Return Fund earlier this year and Boston-based investment advisor Venus Capital has also started an India focused multi-strategy arbitrage fund. Meanwhile, Anurag Bhargava's Indian Real Estate Opportunity fund is tapping into the country's distressed property market and **veteran India fund manager, Jon Thorn, who has been quietly managing the India Capital Fund for the past nine years out of Hong Kong, has seen growing interest in his fund.**

Managers praise the size, breadth and liquidity of the Indian market, the range of derivatives available and reforms which they say have transformed the country's financial services sector. Other industry insiders, however, sound a more cautious note on this populous, complex and still rapidly developing country.

India's equity markets are large and liquid, with a market capitalization of $200 billion and daily turnover of $1.5 billion. Futures contracts are available on 53 stocks and two indices and total daily trading volumes range between $800 million and $1.2 billion. It is not just the size of the market that's appealing — it also has variety, according to Jonathan Boyer. "There is enough breadth to have to have a well-diversified portfolio with winners and losers in each sector," he says.

The perception of India as a high risk market with poor corporate governance and low standards of market practice is out of step with reality, managers say. Boyer characterizes the dramatic changes that India's financial services sector have undergone as "hubris, followed by nemesis and catharsis. The Indian corporate sector was chastened and there has been a dramatic improvement in corporate governance," he says.

"Whereas 10 years ago we were enthusiastic about India, at that time the underlying fundamentals were shaky and valuations were in the mid-20's. Now you've got the opposite — low overall valuations for the market, strong sustainability, strong earnings growth, and significant higher return on earnings," continues Boyer.

"Two to three years ago everything started to change in India," says Jon Thorn. "The whole market fell apart in 2001. There was total investor capitulation and 100% of new investible assets went into government debt. After that everything changed and now it is arguably one of the best markets in the region," he explains, citing T + 2 settlement, mandatory quarterly reporting and segment break-out in reports as well as the creation of single stock and index futures and options.

"I couldn't do leverage trades in India until September 2001 when futures contracts were introduced," says Thorn. The introduction replaced an informal system called badla (the Hindi word for interest) that had operated on the curbside outside the stock exchange reasonably successfully for decades. "On 23 December 2002 the notioned value of the derivative contracts exchanged exceeded the value of the cash market, which was truly amazing in such a short time."

Thorn's fund uses derivatives to leverage long positions rather than take short positions against unfavoured stocks. "Most managers aggressively short overly-valued stocks or try to get market neutral. The problem with long/short is that the fund will potentially under-perform in a rampant bull market. In that situation the optimum strategy is leveraged long, so typically what we do is buy long futures against stocks that we think may have a quick short-term run," explains Thorn.

However, industry insiders who do not manage India funds sound a more cautionary note. One observer warns: "India is a hot market and it's having its day in the sun. At the moment there's a wall of great news about India, but when times get tough again you will hear the same old complaints emerge, about corporate governance and the fact that managers have no ability to keep their dealings confidential."

Regulatory requirements on disclosure are also a problem, he adds. In October, the Securities and Exchange Board of India introduced new rules requiring the bi-monthly notification of the beneficiaries of synthetic instruments. Although the futures market does provide shorting opportunities, the logistics this entails are off-putting for most offshore managers and while synthetics at 25 to 30 basis points on notional exposure are not prohibitively expensive, they will become less palatable when the market is not experiencing a bull run.

For some managers the restrictions on shorting are non-issue. Raj Mishra, for example, feels that there is no shortage of choices to hedge. "We have a slightly long bias and we are using listed futures, options and other OTC derivatives to bring a sufficient portfolio hedge," he says.

For an investor looking for a large, populous Asian country with a vibrant, rapidly-growing economy and lots of under-researched companies, China would likely come to mind, but China mania has deflected attention from what India fund managers assert is an equally interesting story.

"When we launched our fund in late 1994 we thought India presented a fabulous opportunity as the changes taking place there were as large as anything in Asia, as significant as the development of the Special Economic Zones in China. These changes were significant although they took a lot longer to germinate," says Thorn.

A clear understanding of what is required in properly functioning banking system sets India apart from China, says Boyer. "China is a great macro story but a fragile micro story, partly because it doesn't have an efficient banking sector. Lending there is made for relationship reasons. That doesn't happen any more in India.

The outlook for India remains positive says Thorn, and Boyer concurs, citing steady improvements in the macro environment and a broad platform for economic growth.

"Poor infrastructure was a trade bottleneck but that's being addressed. The political situation remains the biggest risk, notably intermittent problems with Pakistan and Hindu national agenda worries, but on the positive side the Indian middle class has more at stake than ever, he says.