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Why India is the new China – but better

29/07/2019

India's economy is primed for growth and its stock markets are set to benefit. In this overview, we set to prove why emerging market investors should look here instead of China and select three funds which could help you reap the rewards.

Economic growth at 6.2% is hardly a figure to be scorned, but the great China growth engine is certainly not what it used to be. Gone are the years of double-digit expansion, driven by a manufacturing economy that was happy in its role as the factory of the world. Today, China must be content with the gradual deceleration that was always inevitable as its economy matured.

Not that the latest phase of the Chinese growth story is necessarily a bad thing. China is attempting to turn from a manufacturing giant to a service led economy – a shift that could bring better equality, healthcare, education and job opportunities. There are therefore big sections of the Chinese markets which still look exciting for investors. Early stage tech and science companies, for example, which have now found a home on the new Star Market, China's answer to Nasdaq. The appetite for innovation is certainly high – shares in companies listed on Star rocketed by as much as 500% on their first day of trading.

But as an article written by Bloomberg stated: "The star that burns the brightest may also burn out fastest. Investors tempted by the blazing debut of China's new tech board should bear that in mind". Western investors have certainly been burned before by over-exuberance in the orient, leading to widespread distrust for Chinese companies and their auditors. Today, with the country in the midst of a full-blown trade war with the US, scepticism is higher than ever.

But many emerging market alternatives are arguably no more appealing. The stock markets in Brazil and Russia might be outpacing China, but these countries have political and trust problems of their own. Growth in Mexico and South Africa has slowed considerably in recent years.

India is a far more attractive option. The BSE30 Index of Indian mega-caps has grown at a compound annual rate of 10% for the last 15 years – faster than any other emerging market stock index. The country's economy arguably looks similar to China's a decade ago, with its GDP expected to grow at 11% a year and double within six years. But India's service-led economy also makes the country far more mature than China has ever been. There is therefore huge potential for exciting, reliable investment returns.

An economy primed for more growth

Half of India's population is below the age of 25, compared to 33% in China, 31% in the UK and less than a quarter in Japan. India's dependency ratio is therefore falling quickly. Recent healthcare improvements also mean that the size of each family is getting smaller – parents don't need to have lots of children to ensure survival. Overall, this means income per household is rising.

In fact, economists are forecasting 30-years of household income growth as India moves from a consumption economy into an export giant with a focus on manufacturing. The political situation will help the cause. India has no role in the current trade war which started as a small tension between the US and China and has bubbled up to impact several major world economies. It could therefore be a beneficiary as the US seeks to reduce its reliance on other Asia countries.

The recently re-elected prime minister, Nerendra Modi has made a number of market-friendly reforms, including introducing a corporate and bankruptcy code aimed at shoring up public banks, and enforcing laws on debt repayments. The act has set the course for better corporate governance and a safer economic system. With fewer potential disturbances to its continued growth than China, there are many reasons to believe the Indian economy can keep growing strongly for the foreseeable future.

Market trends and company qualities enhance the investment case

Domestic-focused companies have an excellent opportunity as the wealth of the average Indian picks up and households begin to spend more on consumer goods, technology and property. For now, most of those sectors are dominated by one or two massive companies. For example, Hindustan Unilever has a 40% share of the bottled shampoo market in India, but there are huge waves of the population who are yet untapped and therefore a massive opportunity for Indian companies with domestic expertise.

The strong outlook does come at a price and Indian markets are at a premium to emerging peers. It is also worth being aware of high volatility – India is not a market for short term investors, those seeking the superior returns available must be willing to invest over a five-year period at least. Liquidity issues are also rife in the small cap space which includes many family run businesses where the founders have retained a large stake.

But both the liquidity and volatility issues are improving as more Indian and foreign investors enter the market. On average, 900,000 new Indian investment accounts are being opened every month as the rising tide of savings in the country is being moved into equity markets.

According to David Cornell, chief investment officer at Ocean Dial Asset Management – which invests exclusively in India – the quality of management in India is one of the key factors which makes the market attractive. Trustworthy leaders with sensible growth plans who have often gained a western education are helping drive massive returns in Indian companies.

Our top three India-focused funds

Stock picking Indian companies via the UK markets is still not as easy as it could be (it is also quite expensive). Fund investment might therefore be a better option. Here are three of the best:

India Capital Growth Fund

- Fund Adviser: Gaurav Narain, Ocean Dial Asset Management
- Annual Fee: 1.25%
- Performance: 20.5% five-year CAGR
- Structure: Investment Trust

The small and mid-cap arena – where this fund specialises – is the fastest growing segment of the Indian market, reporting a 23% CAGR over the last five years. Ocean Dial has therefore underperformed the fund’s benchmark over a five-year period, but it has massively outperformed the MSCI India in the same time and since the fund’s inception.

David Cornell, chief investment officer at Ocean Dial, thinks the firm stands out because it has a team on the ground in India who can assess the real investment cases of each stock and get to know the company's management.

Mr Cornell also thinks the small and mid-cap space is the right place to be because the large companies obtain a lot of their earnings from overseas which "defies the point in being in a market which is growing so quickly". The closed-ended structure of this fund helps to avoid liquidity issues with investing in the small and mid-cap space.

iShares MSCI India ETF

- Fund Manager: Blackrock
- Annual Fee: 0.64%
- Performance: 4.57% five-year CAGR
- Structure: ETF

iShare's tracker is certainly the cheapest way to access the prolonged growth available in India but, as Mr Cornell pointed out, the returns are not quite as impressive as those gained by targeting the small and mid-cap arena.

The fund is also at the mercy of rapid sentiment changes. After several months of solid inflows (including in months where other emerging economies were struggling to find demand), the fund reported outflows of more than 4% in June this year.

But the outlook is inherently tied to the fortunes of the market which, as we have said previously, is very positive. Energy giant Reliance Industries is the fund's largest holdings, with financial companies and consumer goods specialists making up most of the rest of the top ten. There are 79 stocks in the fund, which has a net asset value of $5.2bn.

Jupiter India Fund

- Fund Manager: Avinash Vazirani, Jupiter
- Annual Fee: 1.07%
- Performance: 66% five-year cumulative return
- Structure: Unit trust

Jupiter points to the fact that it has beaten the MSCI benchmark by more than 50% since its inception. But it has struggled recently – unable to outpace the market in any of the last five years. That might be something to do with the strategy – growth at a reasonable price (GARP) – which means the fund has missed some of the best performing (and most expensive) stocks.

But, as the fund's webpage says, "past performance is no guide to the future". This fund focuses on companies which make most of their money in India (including those that are domiciled elsewhere) to help reap the benefits of the fast-growing economy.