A case for long-term investing

Investors in India's stock markets are torn between the benefits of structural transformation of the economy and fear of an unmanageable stock market, writes *Joseph Mariathasan*.

For an emerging market such as India, there is a clear distinction to be made between the riskiness of its economy, and the volatility of its stock markets. One of the most important developments in India over the past decade has been the structural reforms in public policy and management and, following on from that, the perceived riskiness of its economy.

Overall, domestic demand continues to be the key driver of growth in India, rather than exports. Balance sheets are relatively strong in the corporate sector and most households are in a net cash position; fiscal management is now mostly sensible; the inflation dragon has largely been tamed and interest rates are at historically low levels; and demographics are supportive.

In 2008, the Indian stock market fell by 70% leaving investors shell-shocked.

However, in 2008, the Indian stock market fell by 70% leaving investors shell-shocked, only to see a rally this year of 40% from March to June. But G. Pradeepkumar, chief marketing officer of IDFC Investment Advisors, points out that with the BSE Sensex at around 15,000 it has some way to go to get back to the highs seen in March 2008 of 21,000.

Raj Mishra, chief investment officer of Indea Capital, argues that the recent election results in India are a 'game changer' from a long-term perspective. They have produced the most stable government in India for two decades, which may well remain in power for the next decade, encouraging policy consistency, economic reforms and business confidence. In turn, this will attract foreign and local capital, lowering costs of funding for long-term infrastructure projects.

As a result, growth can resume at full capacity, so that GDP growth can revert to its 7% - 8% trend value. Yet despite this, the absence of many long-term domestic institutional investors such as pension funds in India's equity markets means that they are likely to remain volatile for years to come.

Foreign investors facing the challenge of buying into India's growth story while avoiding the worst of the

32-34 IndiaHF.indd 32 18/8/09 11:14:48

market gyrations have the option of investing in long/short hedge funds. The ability to run long/short hedge funds enables fund managers to adjust their exposure to market beta, giving them the ability to benefit from the higher returns expected from a country like India, while protecting themselves to varying degrees from the downside – providing of course that they have some talent.

The first generation of Indian hedge fund managers have proved to be a disappointment, says Nick Paris, managing director of Purbeck Advisers: "They participated in the bull run from 2003 to 2007, but most fared badly when the market fell in 2008, with many losing 50% or more despite claiming to be hedged. They proved to be beta plays with higher fees and as a result, a lot would have gone out of business."

Bill Maldonado, head of alternatives at HSBC Halbis, says: "Most Indian hedge funds were geared exposures to the market and were invested in less liquid stocks which suffered even more when the market fell."

The term hedge fund can be misleading in the Indian context. Halbis's own hedge fund offers a far more market neutral exposure, with typically 10%-20% market exposure, according to Maldonado. However, a non-directional fund such as this would hardly be suitable for investors seeking to gain exposure to the long-term secular growth story in India.

If, as Paris believes, the bull run we have seen from March this year is the start of another long-term bull run of 2 - 3 years, based on India's domestic consumption story, then investors may have to take a view on how much return they would be willing to sacrifice for a reduction in volatility. Paris's view is that talented fund managers who are able to run long/short funds with a focus on absolute returns should do better in India than long-only managers who aim to beat an index by 2%-3% per year.

The development of liquid derivative markets

India as an emerging market is perhaps uniquely positioned for managers adopting long/short equity strategies, having seen a rapid development of its derivative markets over the past decade, including the establishment of currency futures earlier this year. Unlike most other emerging markets, India also has the sectoral diversity to play the growth story in the most liquid names, allowing managers to run multiple strategies through a diversity of instruments.

Most notably India has very liquid single stock futures market. These are widely used by speculators within India, and provide a mechanism for long/short equity strategies that few emerging markets can hope to emulate. Yet as recently as the 1990s, India's stock markets were still using antiquated procedures. Transactions required settlement periods of two weeks, and transfers of shares involved vast amounts of paper being moved by armies of clerks. There was a real risk of fraud, with share certificates turning out to be counterfeit.

This structure did however result in India's equity traders becoming used to the idea of single stock futures trading through the existence of "badla" trading, a crude form of derivative trading. A two week settlement period meant that a trader could buy and sell equities from Monday onwards and would only have to deliver or receive delivery of a net position on the close of Friday, two weeks later. If the net position was zero, he would either receive trading profits or have to pay out losses.

The badla mechanism allowed traders to carry forward long or short net positions to the next settlement period. Large positions could be built up in this way without delivery for months at a time. Like a traditional futures contract, badla provided a mechanism to obtain a leveraged exposure to the market, but unlike a futures contract, the responsibility for the maintenance of marked-to-market margins lay with the broker rather than the buyer or seller or a clearing house.

The catalyst for the development of sophisticated derivative markets in India was the creation of an all-electronic exchange, the National Stock Exchange in 1994, as a response to the failure of the Bombay Stock Exchange to reform itself. The BSE had to also adopt electronic trading to compete, while the development of electronic custody enabled settlement to be undertaken on T + 2 basis.

Badla was abolished in 2001 just prior to the introduction of single stock futures later in the same year. The familiarity with settlement periods and ideas such as carry forwards were translated into activity in the single stock equity futures, ensuring their success. This in itself is noteworthy as single stock futures have generally failed elsewhere in the world.

In contrast, index futures took longer to become popular when introduced in June 2000. The NSE has become the major derivatives exchange in India

32-34 IndiaHF.indd 33 18/8/09 11:14:52

and one of the largest in the world in terms of turnover. Single stock futures account for similar volumes to index futures, with around 200 of the largest companies being traded and half being very liquid.

Options are also traded on both stocks and indices. While settlement has so far been on a cash basis, the success of the derivatives marketplace and the development of its infrastructure have led to recent moves to introduce physical settlement. This would enable a much closer alignment of the derivatives with the underlying stock positions, benefiting hedgers and arbitragers.

For such a move to succeed would also require the development of liquid stock lending and borrowing facilities. The Securities and Investments Board of India introduced regulations in April 2008, but with few participants willing to lend, and difficult operational procedures, the market is not large. This needs to change, along with other issues such as the problem of short squeezing that can arise when there is a large mismatch between lenders of stock and demand, giving rise to unwarranted price increases.

Foreign investors can deal directly in Indian stock and derivative markets by registering with SEBI as a "Foreign Institutional Investor". SEBI imposes some rules on who is entitled to be an FII. Typically, these can be pension funds, mutual funds, investment trusts, endowments and insurance companies with a track record of at least a year.

A variation of the FII route is to become a sub-account of an existing FII, although this does involve restrictions on the type of activity that can be undertaken. A popular alternative to FII registration, used by foreign fund managers taking positions in both long and short in Indian equities, is through Participatory notes (P-Notes).

P-Notes are issued by Indian based brokerages who buy Indian equities and then issue the P-Notes to investors, passing on any dividends. By 2007, P-Notes accounted for about half of foreign investment into India. This caused SEBI some anxiety over the lack of transparency over ultimate ownership and the fear that hedge funds would create volatility in the marketplace.

> "When markets were up 60%, we were up 20%, and when the market fell 60% we were down 20%."
> Raju Kamath, Kuvera Capital Partners

In October 2007, SEBI proposed to impose strict controls on P-Notes which led to the market crashing and then bouncing back as SEBI sought to avert a melt-down. In the end, SEBI invited funds investing through P-Notes to register as FIIs, promising to make the registration process much easier and faster, leading to a market resurgence. As a result, many hedge funds registered as FIIs and used the futures markets to short stocks. But as Raju Kamath, managing director of hedge fund Kuvera Capital Partners, points out: "A lot of Indian hedge funds did not really short stocks but instead, just shorted the index or hedged in cash."

P-Notes are still actively traded. Kamath explains: "Single stock futures are simple to use and the credit risk is mitigated by the use of an exchange, which also gives transparent pricing. The only problem is that you do have to roll the trades every month, which gives rise to a roll-over cost. P-Notes really do not have any disadvantage over futures, but you need to weigh up the costs and the stability of any borrowed stock. At one stage, P-Notes were expensive relative to single stock futures, but the pricing has now become more competitive. One advantage of P-Notes is that you don't need to roll trades every month, so for long-term positions they can be very useful."

Second generation hedge funds

Paris sees 2009 as the beginning of a new era for Indian's stock markets. With many of the first generation hedge funds out of business, those that remain, and new ones that may be set up in the future, represent a second generation in terms of Indian hedge funds: "The survivors should have learnt their lessons," says Paris. So far though, investors in Indian hedge funds have been the traditional investors in hedge funds such as fund of funds, family foundations and private banks. The majority of these are in the US and Europe, but Halbis has some clients in Asia, predominantly from Singapore, Hong Kong and Australia, with some interest seen from Korea and Taiwan according to Maldonado.

While these types of investors would seek Indian hedge funds for high returns, rather than low volatility, Paris sees the ability of the hedge fund manager to avoid being dragged down by closely tracking an index as crucial to the generation of returns. While Halbis' hedge fund maintains a net low market exposure, other managers vary their net exposures to the market quite dramatically. "Our typical exposure can vary from between 20% to 70% net long," says Kamath. "Initially when we set up, the idea was to run a typical hedge fund and manage volatility. When markets were up 60%, we were up 20%, and when the market fell 60% we were down 20%."

But Kamath has found interest from investors outside the traditional hedge fund investor base who see forms such as his own offering an alternative route to the secular growth story. "What has happened though, is that there has been a lot of interest from investors who want exposure to India and are prepared to take on more volatility," he says.

As a result, they have recently launched a fund that is essentially long-only investing in small- and mid-cap stocks that do not have futures traded on them, but will hedge out some of the market risk by using index options. "There are good opportunities in small- and mid-cap stocks but the problem is that when the market falls, they tend to fall even more," he explains.

It is clear that the India investment story should run for many years to come. It is also clear that India has some of the most sophisticated and liquid single stock futures markets in the world. What is not clear is how many talented managers are available who can reduce the volatility of investment in India's equity markets without also sacrificing the return.

32-34 IndiaHF.indd 34 18/8/09 11:14:52