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Go global with your money

The domestic stock market is witnessing a lot of volatility while the US, Europe and China are looking up. It's time to globe-trot

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What's the investment scene like, on the domestic front? Not too inviting at the moment. For one, Indian markets are headed for a phase of extended volatility, going by their expensive valuations. The upcoming Central and state elections and their likely political outcomes are adding to the uncertainty. Moreover, the debilitating effects of the banking fraud on the economy haven't played out fully.

But how are global markets doing even as we are buffeted by headwinds domestically?

Major economies such as the US, Europe and China are reporting strong GDP growth. These geographies present unique investment opportunities in sectors and stocks that are not available back home in India.

Investors looking to diversify their portfolios could definitely consider the international basket of global mutual funds and ETFs for their asset allocation since many of these schemes have delivered better returns than domestic indices.

Indian investors can take exposure to international markets through feeder funds, ETFs based on international indices and mutual funds that invest in overseas equity directly. Feeder funds are domestic mutual funds that usually invest in their overseas arm's (or another global fund house's) scheme which, in turn, invests in overseas equity.

Most international funds available in India would fall under this category. ETFs invest in shares or commodities forming part of indices, in the same proportion as the index. Some of these ETFs are traded in the domestic markets — BSE and NSE. Investors also have the option of investing directly in overseas equity.

We analysed the entire international fund universe of 39 schemes with varied themes to see how they fared. At least a fourth of them have delivered returns much higher than domestic indices over the past three to five years. While the top 10 funds have delivered 15-37 per cent returns over the past one year, their three-year returns of 10-17 per cent place them much higher than the Sensex or the Nifty's returns over these periods.

The returns of the top 10 international schemes were also 3-5 percentage points higher than those of benchmarks such as the S&P 500, Nasdaq, Hang Seng and Shanghai Composite.

Diversified global funds focused on the US and fast-growing Asian economies were the best performers while those focused on gold, commodities or natural resource-intensive economies have failed to deliver.

Opportunities to invest in MNCs of global standing, exposure to sectors unavailable domestically, diversification of portfolio and the chance to participate in relatively cheaper markets overseas — are the compelling reasons why investors need to go global with their investments now.

The rupee has been less of a factor, given that it has been trading in a narrow band against the dollar over the last four years. If the rupee does weaken against the dollar, as interest rates increase in the US, that will only bolster the returns of global funds.

Of course, many international funds have underperformed domestic indices as well as their own benchmarks. Therefore, choosing quality international funds becomes important for superior returns.

Here we look at the types of international funds available, the themes that have worked or failed in terms of their return profile and their suitability for investors. We also analyse the tax angle at play when one takes exposure to global funds.

The broader, the better

Broadly, global funds invest in emerging markets, global indices, commodities, real estate and themes such as agriculture.

An analysis of their returns over the last one and three-year periods shows that two categories of funds managed to go well past their own benchmarks as well as Indian indices.

In the last three to five years and especially over the past one year, funds that invest in the Asian markets — China, Singapore, Indonesia, Taiwan and South Korea — have done extremely well. Several schemes, which focused on the US, too, delivered robust returns.

While quality Asia-focused funds delivered 9-14 per cent annual returns over the past three years, the top schemes investing in the US markets managed to generate 10-17 per cent returns. The one-year returns are far more spectacular as nearly 15 out of the 37 schemes considered for this analysis delivered 15-40 per cent.

These markets offer attractive avenues for investment in sectors such as semiconductors, energy, utilities, mining and telecommunication services.

The US markets also offer opportunities to invest in global pharma majors, e-commerce companies and world-class product software and technology players.

Apart from the variety itself, the scale of many of these companies, especially in the US and China, is massive and they tend to be immune to business cycles or are able to ride out volatile markets with exceptional execution capabilities.

Thus, there is a great opportunity for investors to diversify in terms of sectors, themes and even geographies.

Edelweiss GCE Offshore, Motilal Oswal MoSt Shares – NASDAQ 100 ETF, Franklin Asian Equity, Templeton India Equity Income and Reliance ETF Hang Seng BeES were among the best schemes investing in Asian and US markets.

Some themes were flop shows, though. While gold prices have fallen by 17 per cent in absolute terms over the past five years, the commodities index, CRB, is down nearly 8 per cent over this period. Not surprisingly, funds that bet on gold, agriculture, commodities and natural resource-reliant countries or stocks fared poorly. The real estate theme, too, did not work.

Kotak World Gold (invests in the Falcon Gold Equity Fund - Asia), DSPBR World Gold (Blackrock Gold), Aditya Birla SL Global Commodities(First State Global Resources), DSPBR World Energy and Aditya Birla CEF – Global Agri Plan were among funds that reported negative or anaemic returns over the past one to three years. Some schemes have even given negative returns over a five-year period.

The stocks and segments that these funds have invested in reveal why many themes have not played out well and have in fact dragged returns.

For example, gold mining companies such as Barrick Gold and Kinross Gold have witnessed share prices decline of over 50 per cent over the past five years. Even after a recovery in 2016, stocks such as Rangold and Newcrest Mining are down over 30 per cent off their peaks. So, gold funds investing in these stocks suffered NAV erosion.

Crude oil prices were down over 70 per cent from their peak and are still at less than half of their $140 levels four years back. So, the energy theme too took a hit in the last 4-5 years.

Seed manufacturing companies, fertiliser players and crop nutrient manufacturers within the agriculture theme have not had a great run over the past couple of years and have therefore hurt the returns of funds investing in such themes.

The inference from the divergence in performance between diversified schemes and thematic funds is simply this — investing in a broad-based basket of stocks and sectors pays off in the case of overseas investments as well.

For theme and commodity-based funds, investors have to take multiple calls on the economic and business cycles and time their entry and exit, a call that would be quite challenging for retail investors.

Rupee matters little

The movement of the rupee against the dollar is one factor that may have investors in international funds twitching nervously at the prospect of erosion of returns or cheering at the possibility of the currency fall buttressing NAVs.

In the worst days for the rupee between 2010 and 2013, when the rupee depreciated by more than 50 per cent against the dollar, international funds were able to register NAV gains singularly from the fall in currency.

Even if the underlying portfolio did not deliver well, the rupee depreciation meant that these funds reported healthy returns. But over the last 4-5 years, the rupee has remained fairly stable at 63-65 levels against the dollar. Thus the healthy returns that the top quartile of international funds delivered are largely due to the performance of the underlying stocks and sectors.

India is likely to run up a higher current account deficit this fiscal thanks to rise in crude oil prices and slowing exports. Fund outflows due to foreign portfolio investors reallocating funds to the US due to increasing yield and rising dollar are also expected to pressure the rupee. A breach in the fiscal deficit target is also on the cards. Measured by the real effective exchange rate (REER) metric, the consensus is that the rupee is overvalued.

Thus, the rupee is expected to remain volatile and is unlikely to strengthen any time soon. Bloomberg estimates based on analyst forecasts suggest a median rate of 64.7 as the likely level for the rupee by the first quarter of 2019. Any fall in the rupee would benefit international funds. Even if the rupee trades firm within a narrow band, it would not be a critical factor in determining or altering returns.

Valuation comfort, globally

After the massive rally of 2017, Indian markets seem to have entered the expensive valuation zone. A large number of mid-cap stocks have even got into a bubble zone.

The Nifty 50 trades at 22 times trailing earnings and at a price-earnings multiple of 19 times forward earnings, according to Bloomberg estimates. The BSE 500 index trades at a whopping 25 times trailing earnings. Thus, domestic markets are in expensive territory.

On the other hand, global markets are cheaper. For instance, the S&P 500, FTSE 100 and NASDAQ trade at just 12-16 times forward earnings, according to Bloomberg.

Asian indices such as the Hang Seng, Shanghai Composite and Nikkei 225 are even cheaper, as these trade at just 11-13 times forward earnings and about 13-15 times trailing earnings. Thus, despite the rally in several global, emerging and developed markets, there is considerable valuation comfort to continue investing overseas.

An IMF report indicates that global GDP is set to increase at a healthy 3.9 per cent in 2018. Asia Pacific countries are expected to grow by 5.4 per cent, while China's GDP is set to increase by 6.5 per cent. Despite growing at this rate, markets in China are quite cheap relative to India.

These growth figures point to the fact that investors can gain by taking exposure to overseas markets.

Asset allocation, taxation

From the discussion above, it becomes clear that investing in international funds, ETFs and overseas fund-of-funds is indeed an attractive option.

However, it is important to be choosy about which schemes to pick for your portfolio.

First, it is ideal to stick to diversified funds which invest in a basket of stocks focused on Asia or the US.

Second, you must avoid theme and sector-based global funds as they are highly cyclical and require you to time the entry and exit, which is not easy.

Third, as with domestic funds, you must invest for the long term of 5-7 years at least to gain meaningfully from overseas exposure.

Among funds with more than five years' track record, the following funds appear attractive: Motilal Oswal MoSt Shares NASDAQ 100 ETF, Reliance ETF Hang Seng BeES, Templeton India Equity Income, Franklin India Feeder – Franklin US Opportunities Edelweiss GCE Offshore and Franklin Asian Equity.

Investors can choose two or at the most three schemes from the above set for diversification.

It is also important to note that for investors with moderate risk appetite, international funds should not form more than 10 per cent of their overall portfolios. The amounts parked must only be the surplus that you are left with after exhausting all important avenues domestically.

International funds and ETFs are treated as debt funds in India. Therefore, long term capital gains are taxed at 20 per cent.

Since these are debt funds, the minimum holding period for gains to qualify is three years. If you sell units before three years, the profits would be treated as short-term gains and taxed at your slab rate.

As mentioned earlier, if you invest with a long-term horizon, this lock-in period of three years should not be a worry.

Also, you would get the benefit of indexation for inflation, which is not available even to domestic equity funds. For example, let us assume that your annual returns are 12 per cent for a five-year period and inflation is 6 per cent over this horizon.

So, if you invest ₹1 lakh, it would grow to ₹1.76 lakh in five years. But as inflation is 6 per cent, your cost price would be ₹1.34 lakh.

Thus you will have to pay 20 per cent tax on the ₹42,000 long-term gains that you make after indexation, which would be about ₹8,400.Effectively, that would mean a tax outgo of only 4-5 per cent. Thus, in an inflationary environment, such investments would be attractive.

While Indian markets are attractive over the long term, there is definitely a case for investors to spread their investment net overseas to capture a slice of the overseas rally.

GLOBAL FUNDS THAT DELIVERED

Returns (%)

Fund	1 year	3 years	5 years
Motilal Oswal MoSt Shares NASDAQ-100 ETF	25.9	16.8	23.5
Franklin India Feeder - Franklin U.S. Opp. (G)	20.4	9.5	16.5
Templeton India Equity Income Fund (G)	18.7	10.4	15.6
Edelweiss GCE Off-Shore Fund(G)	40.1	14.0	14.5
Reliance ETF Hang Seng BeES	27.5	11.8	12.2
Franklin Asian Equity Fund (G)	27.3	11.9	11.2
Indices	**1 year**	**3 years**	**5 years**
Nasdaq (US)	24.1	13.7	17.8
S&P 500 (US)	14.2	9.0	12.1
Hang Seng (Hongkong)	24.1	7.3	5.8
Nikkei 225 (Japan)	9.0	3.9	12.5
CRB Commodities Index	3.0	2.1	-1.5
Nifty 50	14.3	4.7	12.0