India's path to becoming a world-class stock market

As investors in Asia and global emerging markets, FSSA Investment Managers believe India has been an amazing investment destination – over the last 10, 20, or 30 years, companies in India have created a significant amount of wealth for shareholders. In early 2024, its equity market capitalization rose above $4 trillion to became the fourth largest in the world, behind the US, China, and Japan.

FSSA Investment Managers began investing in India 30 years ago. Throughout this time, they have consistently found great opportunities in the market, regardless of whether it was in favor or popular.

Over the years, India's market has undergone significant changes in terms of market size, the number of companies investable, and the amount of institutional and foreign ownership.

FSSA Investment Managers have witnessed the transformation of small, family-run businesses into professionally-managed listed companies, with the next generation of leaders often educated in the West and equipped with the knowledge to create shareholder value. This has meant continuous growth in the number of companies investors consider to be investable.
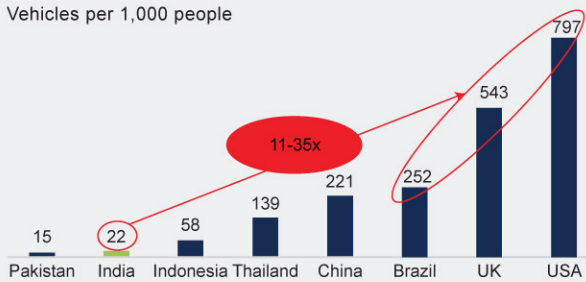
Two decades ago, under-penetration in consumer staples categories was a compelling investment case in India. Whether it was soaps, detergents, or shampoo, per-capita consumption in these categories was significantly low. The leading companies generated substantial cash flow, and high returns on capital, and established strong competitive advantages.

However, the penetration story in those categories has reached its peak as incomes have risen. Going forward, the focus will shift towards discretionary products and premiumization. In financial products, for example, customers have been shifting their money from basic bank deposits to invest in insurance products, engage in wealth management, and directly participate in equity markets.
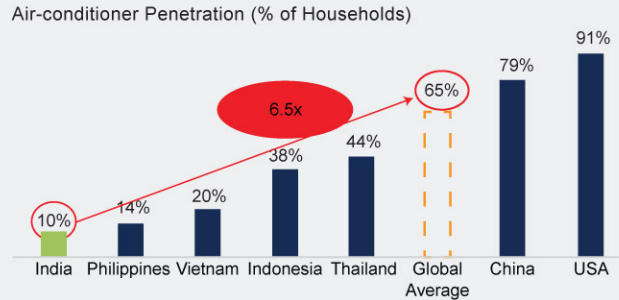
In the consumer discretionary sector, despite a population of 1.4 billion people, less than 10 million air conditioners are sold annually in India, compared to 70 million in China with a similar-sized population. This implies significant growth potential ahead.
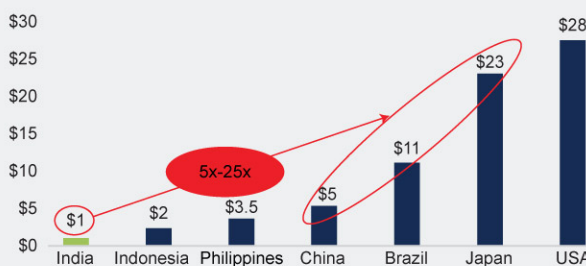
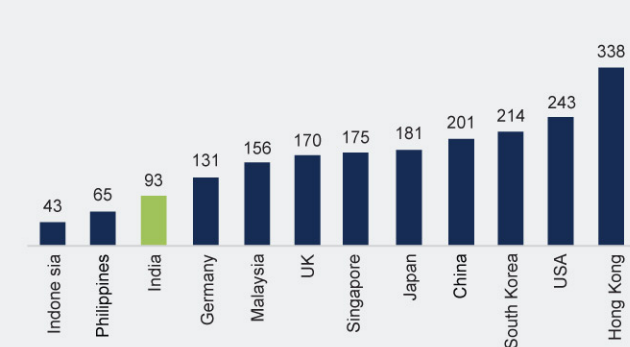## Chart 1: Growth runway is still long

Vehicles per 1,000 people — Pakistan 15, India 22, Indonesia 58, Thailand 139, China 221, Brazil 252, UK 543, USA 797 (11-35x)

Air-conditioner Penetration (% of Households) — India 10%, Philippines 14%, Vietnam 20%, Indonesia 38%, Thailand 44%, Global Average 65%, China 79%, USA 91% (6.5x)

Per-capita spend on Oral Care Products per Annum (US$/capita) — India $1, Indonesia $2, Philippines $3.5, China $5, Brazil $11, Japan $23, USA $28 (5x-25x)

Private Credit to Gross Domestic Product (GDP) (%) — Indonesia 43, Philippines 65, India 93, Germany 131, Malaysia 156, UK 170, Singapore 175, Japan 181, China 201, South Korea 214, USA 243, Hong Kong 338

Source: Euromonitor, Goldman Sachs, FSSA Investment Managers, March 2023.

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In addition, looking ahead it's believed that manufacturing will become an important part of India's economy and investment universe. Currently, many companies rely on imports for components, which they then assemble and sell the end product. However, as these companies grow, they are also investing in manufacturing capabilities. With a large domestic market, the scale of local manufacturing should increase, leading to benefits of scale and potential export opportunities.

Meanwhile, global multinational companies are seeking to diversify their supply chains away from China, and India has emerged as a viable alternative. The Indian government has also implemented incentives to encourage more manufacturing in the country, creating further opportunities.

The Bombay Stock Exchange is the oldest stock market in Asia, and one of the oldest in the world. One aspect that has remained unchanged in India is the focus of company owners on earning high returns on capital. This has always been a priority for Indian owners, given the historical capital constraints in the country.

FSSA Investment Managers have a preference for family-owned businesses because they tend to think in terms of multiple generations, as opposed to completely professionally-run businesses which focus on shorter time horizons. In India, there are several families that have successfully run their businesses for multiple generations, in some cases more than 100 years. Their long track records allow investors to assess their decision-making during challenging periods and evaluate how they have treated stakeholders while growing their businesses.

Meanwhile, governance standards in India have consistently improved, with regulatory standards for minority shareholder protection being significantly more advanced than in other markets. Factors such as the quality of boards, including the minimum number of independent directors, board diversity, and auditor tenure, are strongly regulated in India. These regulations contribute to the overall quality of companies and enhance investor confidence.

FSSA Investment Managers adopt a bottom-up approach, focusing on identifying good companies run by good people. The definition of risk revolves around the potential for losing money, rather than underperforming an index or a random collection of companies.

Given the long-term perspective, FSSA Investment Managers do not spend time forecasting short-term numbers such as quarterly earnings. Instead, they concentrate on identifying the right individuals or families to support. They assess whether they can build successful businesses over the long term and whether interests as minority shareholders align with theirs.

When engaging with companies, the objective is not necessarily to seek agreement but to gauge their openness to stakeholder engagement. Their response provides an insight into how they would treat stakeholders, including distributors, suppliers, employees, and the community in which they operate.

FSSA Investment Managers visit India around six times a year, engaging with management teams as well as researching competitors, suppliers, and distributors to conduct reputational checks. These checks, such as verifying if suppliers are paid on time, provide investors with a deeper understanding of the people behind the businesses.

Investors often ask about valuations in India. Near-term valuations aside, India's equity market offers significant shareholder protections, a strong focus on capital returns, and a young, educated, and aspirational population that is rapidly urbanizing. Perhaps these favorable dynamics warrant a premium?

However, it's acknowledged that India's market capitalization to GDP ratio, a measure of broad valuations, is currently at a decadal high of 150%. And the valuations of many small and mid-cap companies, particularly in certain sectors, may be questionably high. Nevertheless, investors remain prudent and are confident in the ability to preserve clients' capital during challenging periods and steadily grow it over the long term.

Source: Company data retrieved from company annual reports or other such investor reports. Financial metrics and valuations are from FactSet and Bloomberg. As at 22 May 2024 or otherwise noted.

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Systematic Investing and AI

Today, advisors and institutions face many challenges. For example, how to consistently generate outperformance and/or income in a portfolio while keeping costs down? How to build portfolios that incorporate differentiated or unique strategies? How to find managers that can produce excess returns in markets?

Systematic investing has adapted to address these challenges. Systematic investing, sometimes called quantitative or "quant" investing, applies rigorous research and measurement techniques to all aspects of the investment process.

How do systematic and fundamental investment approaches differ?

In practice, fundamental and systematic approaches share many characteristics; however, they employ differentiated processes and techniques in pursuit of a similar goal — alpha.

	Systematic	Fundamental
Daily portfolio management	Model driven with portfolio manager oversight	Portfolio manager-centric with full discretion
Primary form of analysis	Quantitatively and qualitatively testing ideas	Collective expertise, debate, and team consensus
Core competency	Breadth of holding analysis	Depth of holding analysis
Alpha source	Time-varying, repeatable insights	Idiosyncratic opportunities
Positions sizing	Portfolio optimization and risk-budgeting	Conviction
Downside risk management	Defensive portfolio construction	Flexibility and adaptability

Source: BlackRock. The above list is shown for illustrative purposes only, is subject to change and is not an exhaustive list. There may be other differences between investment approaches that are not material and are not detailed above.

In recent years, two key elements of investment management – stock selection and portfolio construction – are being enabled by advancements in two domains of Artificial Intelligence (AI), which are Natural Language Processing (NLP) and Advanced Machine Learning (ML). Systematic investing is able to add differentiation in the market with the application of traditional quantitative insights and AI tools that embed ML and NLP.

Systematic investing looks to harness state-of-the-art technology to analyze hundreds of data signals in pursuit of an investment edge. For example, NLP techniques can review local text in regulatory filings, news articles, broker reports, and social media updates. It identifies early investment signals via sentiment analysis. AI tools and data availability help investors to better understand corporate intentions through analyzing hundreds of data points, for instance, tracking millions of online job postings can help to gauge the health of thousands of companies at the same time or to target future growth areas based on the skill sets in demand. In a meantime, the rate of hiring can be a proxy for activity at the company, industry, or country level.

BlackRock Systematic investment capabilities are developed through pushing boundaries in the fields of alpha research and product innovation, embracing the evolution in sources of investment-relevant information. The BlackRock Systematic Active Equity (SAE) team manages $151billion of assets, with a 38+ year history of generating differentiated results, supported by 90+ investment professionals. The platform combines cutting-edge technology, scientific research, and human insight with the goal of achieving superior investment performance.

On NLP, BlackRock (SAE) team has been using text analysis on broker reports and company earnings calls since 2007. The team is currently in the process of refining and evaluating its 4th-generation earnings call and 6th-generation broker sentiment signals. SAE team uses Large Language Models (LLMs) that are trained on tens of millions of documents, including news stories, books, and websites. The LLMs will then be used to tune the investment model using earnings call transcripts.

Why Systematic approach today?

Systematic approach integrates human insight, big data, and machine learning/AI to select stocks. The research driven process is able to react to changing market environments with 50+ new tactical signals developed in 2020.

The use of systematic tools has made the "impossible" possible in dividend capturing. Using machine-learned LLMs to extract differentiated insights, The team efficiently forms an alternative view of a company's future return potential relative to other companies across the entire market. The team's investment models help them forecast the dividends for over 3,000 companies in the market — which is practically only possible through a scalable, systematic investment approach.

Through this systematic lens, it's believed the team can devise better ways to anticipate, and efficiently capture — or harvest — dividends.

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The team does this through a "dividend rotation" strategy that forecasts payment dates to more efficiently allocate capital to firms with variable dividends when more yield is available. For example, if three stocks each has a 1% yield, and pay their dividend at different times of the year, portfolio managers can theoretically source 3% income annually at the portfolio level. With dividend payment dates ranging widely across markets, a systematic approach helps investors time these payments. Moreover, harvesting dividends and rotating into other stock-specific opportunities could have helped income investors generate additional returns.

Chart 1: Monthly dividend yield breakdown by selected markets in global equities (MSCI ACWI)
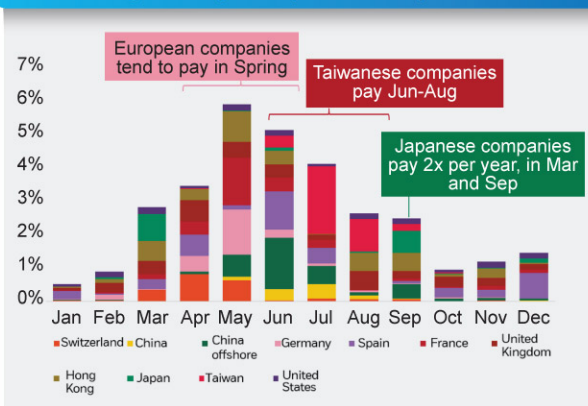
Source: BlackRock. Average yield paid each calendar month by companies in selected markets 2018-2022. Data as at 30 June 2023.

There is no guarantee that a positive investment outcome will be achieved. The Manager cannot guarantee that the intended target rate will be achieved. In addition, over time the target rate is subject to change at the Manager's discretion.

Investment philosophy and process subject to change and provided here for illustrative purposes only. Source: BlackRock, as of 30 June 2024. There can be no guarantee that the investment strategy can be successful, and the value of investments may go down as well as up.

While dividend strategies held up better than broad equity markets in the most recent sell-off in 2022, uncertainty lingers around interest rates staying higher for longer and market volatility remains elevated, and so there is a continued need to evolve income strategies to be able to deliver positive inflation-adjusted returns, irrespective of market environment.

How did the systematic approach enable investors to capture opportunities in the market?

Example 1: Company A

Company A is a multinational technology company, which engages in providing online retail shopping services as well as global sales of computer, storage, database, and other services. The stock went up 19% in Q1 '24 following a 25% earnings surprise. The stock drifted up in Q2, with positive momentum brought by strong cloud revenue, offset by a weaker retail outlook.

What did the SAE model tell investors: The systematic model had a positive view on Company A, driving an overweight and strong cumulative return for the strategy. Both macro and tactical signals were strongly positive as Company A is positively exposed to the AI trend and expansion in AI infrastructure buildout. Quality signals that look at companies hiring in technology-related jobs and spending more on R&D, contributed to the overweight position.

Chart 2: Systematic Income Model View
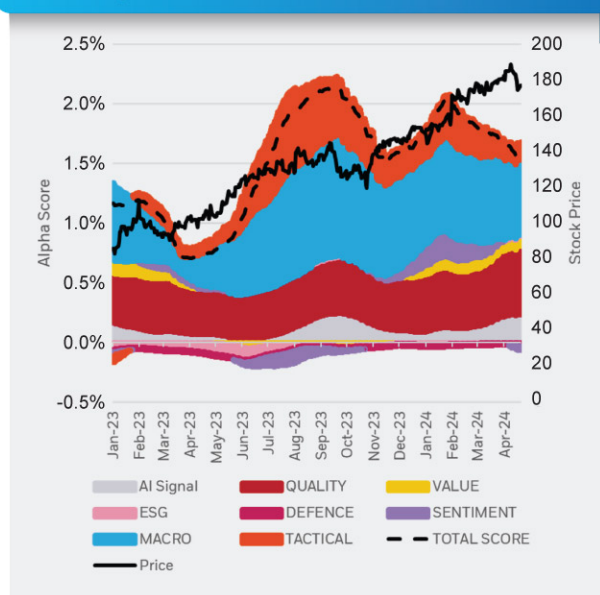
Source: BlackRock, as of 30 April 2024 for illustrative purposes only. The examples provided are for illustrative purposes only and do not represent optimal choices and are not intended to state general or individual investment advice. Investment involves risks, and past performance is not indicative of future performance. The information contained does not take into account full market conditions and your financial situation. You should assess whether the information is suitable for you in light of your personal objectives, financial situation and needs.
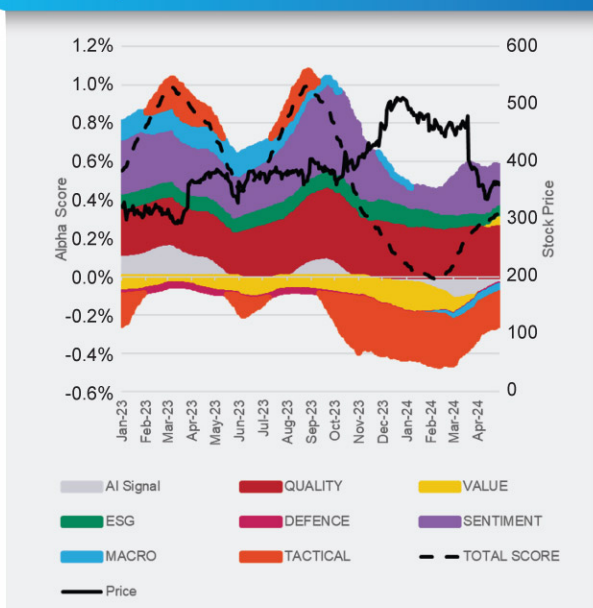
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Example 2: Company L

Company L engages in the business of designing, distributing, and retailing technical athletic apparel, footwear, and accessories. The stock fell 24% in Q1 '24 as they guided earnings downwards. The weakness persists in Q2 '24 despite better-than-feared earnings, with the stock falling another 20%, as the company announced leadership changes and was contending with a slowdown in the Americas.

What did the SAE model tell investors The systematic model had a positive view on Company L from a diverse set of signals going into Q4 '23. However, the signals started to moderate going into the end of the year driven by negative impulses from higher wage costs and consumer markets exposed to mortgage-cost pressures. The strategy closed its long position in Nov anticipating the slowdown in sales announced in Q1.

Chart 3: Systematic Income Model View

Source: BlackRock, as of 30 April 2024 for illustrative purposes only. The examples provided are for illustrative purposes only and do not represent optimal choices and are not intended to state general or individual investment advice. Investment involves risks, and past performance is not indicative of future performance. The information contained does not take into account full market conditions and your financial situation.

Conclusion

A desirable outcome for most income-focused investors is the ability to generate higher levels of income, at lower levels of risk, with a diversified portfolio. The integration of AI and machine learning tools, particularly those utilizing ML and NLP has significantly advanced systematic investing. The Systematic approach, that capitalizes on data availability, computing power, and strategic rotation into specific stock opportunities, seeks to generate positive returns for investors.

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