Channeling household savings into equities: Challenges and opportunities

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Since 2003, Foreign Institutional Investors have pumped in USD 125 billion into Indian equities and their ownership has crossed 20% of our market capitalization while domestic investors have been net sellers over the same period. Our markets have got highly correlated with global events and gyrate to the tunes of 'risk on-risk-off' trends. Dominance of foreign investors has repercussions not only on the financial markets (with inter-linkages among equity, debt and currency) but also on the real economy.

For a variety of reasons, domestic household savings have been declining for last few years and more worryingly, a larger part of that saving is going into physical assets like real estate and gold. Despite all the reforms and structural developments in the capital markets over the last two decades, individual ownership of equity (and bonds) as an asset class is at a historic low. Morgan Stanley Research estimates that share of equity investments in total household assets (at cost) is at 25 year lows of 4% and even lower than 5-6% a decade ago. This trend poses risk of acute shortage of supply of risk capital in the economy despite having a high savings rate.

The severe under-ownership of equities in household portfolios should be a cause of concern. While lack of financial literacy, preference for other alternatives (unregulated savings instruments, physical assets), limited distribution reach, lack of policy and regulatory support etc are oft quoted reasons for this situation, this article will focus on some other issues that need attention. First, a perception has got created that equities or equity funds don't deliver good returns and this is a highly risky and volatile asset class. We will deliberate on what the reasons behind this perception are and how it can be changed. The second issue is related to institutional reform pertaining to retirement savings.

A. Perceptions about equity investing and what needs to be done

India has not seen a sustained bull market: We did not have a very long term sustained bull run in Indian equities. Though the longer term equity returns look attractive but they have come with higher volatility with sharp rise and deep corrections over short time periods. The bull runs have been typically medium-term, lasting for 2-5 years, unlike the runs seen in gold and real estate or the decade-long Bull Run seen in the USA in the 1990s that created the popular notion of "Stocks for the Long Run". Over the last 25 years, the 3 bull markets that we have seen in India all lasted for below 5 years: the Harshad Mehta led 1991-1992 peak, the technology led 1999-2000 peak and the infrastructure-led 2007-2008 peak.

Market Timing: Unfortunately, investors would tend to enter the Indian equity markets or equity funds after 2-4 years of the bull run has passed; leaving them at the mercy of the ensuing market correction. Hence, this builds a perception that stocks are a speculative asset class with manipulated prices with no intrinsic value.

Incorrect sector and stock selection: Entering the market after 2-4 years of a typical bull run, investors advised by their distributors tend to chase funds invested in the highest momentum sectors. Whether technology in 1999-2000 or infrastructure in 2006-2008, many of the stocks chased by investors by choosing sector / thematic funds and even stocks overweighted by fund managers in diversified funds would likely already have moved up significantly before they enter eventual investor portfolios. This limits return potential as large part of the gains are behind and leave investors remain vulnerable to a correction in those stocks or sectors. Due to overweights in these "in vogue" sectors and stocks, investor portfolios and even mutual funds could underperform a broad market index during a market crash or correction unless they are able to time their exit correctly (which is clearly difficult).

How can investors and fund managers beat this?

Volatility has always been a part of equity investing. However over the long term, equities have outperformed almost every other asset class. In India, assume one had invested Rs. 1 lakh each in fixed deposits, gold and Sensex in 1979 (inception of Sensex). As of March 2013, the value would have become around Rs. 16 lakhs, Rs. 37 lakhs and Rs. 1.9 crore respectively. In percentage terms, the annualized return for the three asset classes is 8.4%, 11.2% and 16.6% respectively. In fact, after account for dividends received from equities, the annualized return from investing in Sensex since inception is close to 18.6%.

Sensex has produced positive annual returns approximately 68% of the time period and negative returns roughly 32% of the time period. But if one were to look at returns over a longer time frame, on a rolling 10-year basis, returns have been positive in 95% of the observations. In fact, both in India and abroad, following a negative 10 year return period, the subsequent historical

10-year returns have been strongly positive.

In general, investors would do well to avoid timing markets and remain invested in a few good diversified equity funds for long-term periods. The long-term argument tends to get contested by investors, who are staring at a flat equity market for the last 5 years. This would, however, re-inforce the regular averaging benefits that Systematic Investment Plans (SIPs) provide. In fact, investors would do better to stick with their equity SIPs for longer periods, rather than terminating them by getting dissuaded by sideways to downward markets over the short to medium term. Also, investors would do better to avoid sector / thematic funds, unless they are consciously using these funds for portfolio balancing for their specific needs post thorough research.

Fund houses would do well to focus on processes, rather than 'star personalities' to sustain performance. Earlier, focus on returns was sufficient for fund managers, while paying lower attention to risks, particularly relative to benchmark.

Assuming that systematic investing reduces market timing risks, the key function now of an active fund manager is to generate returns in excess of the benchmark. Research from developed markets shows that the majority of fund managers tend to underperform their benchmarks. In the Indian context, we find that the market is difficult to beat in the large-cap category, with the Nifty Index remaining between the 2nd or 3rd quartile of performance on most occasions (annual returns taken monthly from December 2010 to May 2013). However, when we look at the midcap category rankings, the CNX Midcap Index falls into the 3rd and 4th quartiles on most occasions (annual returns taken monthly from December 2010 to May 2013). This clearly implies that Indian mutual fund managers add more value in mid cap stock picking.

Why does this happen? It could be because of two reasons. Firstly, largecap stocks have greater research coverage (sell-side analysts tend to cover stocks that could generate higher brokerage commissions), hence it is hard to find stock specific drivers that the market has not already factored in, while in midcaps bottom up research could lead to finding stocks that may have been unrecognized by the market. Secondly, because India tends to be an FII flows-driven market, with 21% of the value of NSE listed stocks owned by FIIs who tend to invest more in the large cap and mega cap stocks, which leads to relative mispricing in midcap stocks, which can be exploited by mutual fund managers and other domestic institutional investors due to their proximity to smaller local companies and relatively larger research teams.

Consistency of fund manager performance is an important monitorable for investors. As the Indian equity markets have greater number of investors and analysts tracking them, benchmarks become harder to beat consistently even for skilled mutual fund managers and they may need to manage their fund risk profiles in a better manner. The time has come for them to look at imposing risk constraints like maximum sector or stock overweights and underweight limits as well as tracking error and benchmark coverage ratio permitted ranges. Statistical portfolio risk management packages could be of help in this regard, so that fund managers understand their risk and generate superior risk-adjusted performance for their investors. As the market matures, it would help if fund investors, distributors and research houses question fund managers about how they generate superior risk-adjusted performance, and not just focus on returns independent of risk. Fund houses would do well to impose templates and risk budgets on fund managers, suitable to the fund mandates.

B. Retirement savings into equities

Let's look at the global trends, in the USA, post required legislative changes in the 1970s, retirement funds money flowed into 401(k) plans and Individual Retirement Plans (IRAs). As of end-2012, of total retirement assets of USD 19.9 trillion, the size of assets in 401(k) plans was at USD 3.6 trillion with USD 2.1 trillion of this invested in mutual funds, and in IRAs was at USD 5.4 trillion with USD 2.5 trillion in mutual funds (Source: The Investment Company Institute). The situation in India is quite different, where hardly any retirement funds come into mutual funds or equities, with EPFO and pension funds going into debt securities. Even the National Pension Scheme (NPS) has a corpus of Rs 33,000 crores, of which below 10% would be in equities.

India would benefit from an investment vehicle similar to the 401(k) plan which allows employees to save and invest for their own retirement savings. Similar to India, in USA, interest in equities and related mutual funds waned post the equity bear market of 1973-1974. In 1980, a comparatively miniscule 46 lakh US households owned mutual funds, a 5.7% penetration rate. However in 1981, IRS issued proposed regulations on 401(k) plans that sanctioned the use of pre-tax employee salary reductions as a source of retirement plan contributions. Many employers replaced older, after-tax thrift plans with 401(k) plans. Within two years, surveys showed that nearly half of all large firms were either offering a 401(k) plan or considering one. By 1990, number of plans with a 401(k) feature ballooned to around 100,000 with 20 million active participants and total assets of USD 385 billion. 401(k) plans allow participants to direct their retirement plan accounts and plan sponsors are required to offer at least three investment options covering a range of risk and return. Since inception, the composition of 401(k) plan assets has increasingly moved toward diversified stock investing, often through mutual funds. In 1989, only 8% of 401(k) plan assets were invested in mutual funds, compared with 50% by 2005. As plan participants became increasingly comfortable with long-term investing, equity investments including company stock and mutual funds represented about two-thirds of 401(k) account balances by 2005. Interestingly enough, even on the heels of a bear market that lasted from 2000 to 2002, ownership of mutual funds among plan participants did not come down significantly indicating a measured

response even in the face of significant decline in equity prices.

In India, such 401 (k) type plans would ensure maximum utility of capital- they promote individual savings (employers often match employee contributions), provide incentives to save for long-term and provide disincentives for dissaving (tax on premature withdrawals). Such retirement plans can also serve a balancing role in the equity markets. In US, 401 (k) plans control a significant portion of all financial assets. In India, a similar scheme can pool in significant savings and match up to other domestic financial institutions as well as FIIs.

While the current macro environment might look gloomy and investor confidence may be at nadir, we shouldn't lose sight of the longer term issues. The economy will have a huge need of risk capital and on the other side; there is large pool of household savings which must be channelized into the capital markets. This is also essential to ensure domestic investors participate in the growth story of India and earn inflation beating returns over the longer term to achieve financial security. We must reduce excessive reliance on volatile foreign flows. Focusing on the issues highlighted in this article will help in putting the institutional mechanism in place with a conducive policy framework and supporting infrastructure. Policy makers and investing community need to work together with a sense of urgency.