# High FPI ownership of Indian equities creates strong global market linkages

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As per CDSL data, as of end-June FPIs had $306bn in equity investments in India, owning nearly 20% of Indian equities by market capitalization, and 40% of the free float. Not surprisingly, they also accounted for 41% of the trading volumes in the March 2016 quarter. This high ownership is an important reason for the positive correlation exhibited by Indian equities and global markets despite the Indian economy being among the least impacted by global economic volatility. FPI behaviour is therefore tracked with great interest, with "foreign selling/buying" a key factoid in daily trading summaries, and the level of "FII Ownership" in a stock an important consideration for many investors and analysts.

There are however several commonplace assumptions that deserve to be challenged. We deal with two important issues in this article, in the process addressing several misconceptions. Firstly, other Emerging Markets (EMs) or Non-Japan Asian Markets (NJA) are considered the most appropriate valuation benchmark for Indian equities, with India's P/E premium/discount against EM/NJA tracked diligently: we believe this should change. Secondly, FPI inflows and outflows are associated with market ups and downs: many commentators, incorrectly in our view, assume that the market cannot move up without heavy FPI inflows, and vice versa.

**What's the right valuation benchmark for Indian equities?**

FPIs are not one monolithic entity, but consist of a wide spectrum of asset managers: from Mutual Funds, Investment Trusts and Broad-Based Funds to Sovereign Wealth Funds, Pension Funds and Central Banks. For each of these entities, the sources of funds are different, affecting their investment horizon, as are the investment mandates, making their behaviour differ meaningfully.

Mutual Funds and Investment Trusts are mostly benchmarked investors, mandated to not deviate significantly from the benchmark (else their respective risk managers get involved), and in the process have to get involved in most stocks in the benchmark, be it the MSCI, the FTSE or the Nifty/Sensex/BSE100. Broad-based funds on the other hand, which presumably include hedge funds, are unlikely to be benchmarked, and are more stock-specific in their approach. Pension Funds, Sovereign Wealth Funds and Governments/ Central Banks have very long investment horizons, and are much more deliberate in changing country allocations: many a times these are based on the country's share of global GDP rather than on its share of market capitalization.

Sometimes the classifications that we see from CDSL can also be unclear as to the original pools of savings that are getting deployed into India. For governments/ central banks, for example, given their general lack of interest in stock-specific investments, passive index-tracking ETFs are likely to be the investment vehicle of choice. Thus, the pools of capital in index-tracker ETFs range from macroeconomic funds that can trade in and out within weeks if not days, to retail investors looking for low management fees but who have a slightly longer horizon, to Sovereign Wealth Funds and Central Banks who are likely to be much more patient.

Or, take the confusion around the behaviour of Sovereign Wealth Funds (SWF) over the past two years. Given that nearly 60% of assets globally with SWFs (US$4.2 trillion out of US$7.3 trillion) are Oil & Gas related, the sharp decline in oil prices forced redemptions from many of these funds, which got much publicity. On the other hand, over the past year, SWF holdings in India have gone up by nearly US$8.5 billion.

The simple explanation for these seemingly conflicting trends is that SWFs started off by allocating more funds to external asset managers. These were redeemed as budgetary pressures built up for their governments. Given the poor prospects for EMs, some EM fund managers bore the brunt of these redemptions, and had to pull money from India too. On the other hand, some large non-Oil & Gas SWFs have continued to see inflows, and these continue to flow largely according to pre-set formulae. Moreover, many SWFs, in order to reduce their costs, have over time been cutting outsourcing as well, and this is reflected in greater direct ownership. As a result, over the last two years SWFs' share of FPI ownership has increased from 7.8% to 10.6%, and, together with Pension and Insurance Funds, they now account for 18% of total FPI equity investments. This is a healthy trend from the perspective of market stability.

In total, about two-thirds of investments seem to be through Mutual Funds, Investment Trusts, and Broad-Based Funds. We ran through the list of all funds listed on Bloomberg that have India allocations, and classified them into Global Funds, Emerging Market Funds, Asia Funds and India Funds. The results were very educative.

We found that nearly 25% of this category of funds is India dedicated (20% active, 5% passive, i.e. index tracking ETF). Another 20% (18% active, 2% passive ETF) is through Global Funds' India allocations. EM and Asia funds only add up to about 40% of the set.

This has very meaningful implications for markets: among other things, the traditional comparisons made by many analysts, where India's P/E ratio is compared to that of EMs or NJA, seem inappropriate. Given that Broad-Based Funds (which would be mostly hedge funds) are generally not benchmarked, the share of FPI funds where the fund manager has to compare India's valuation to EM/Asia would be even smaller than 25% of FPIs. On the other hand, for India funds or Global funds, the more appropriate benchmark would be global equities. Indeed, some of the longer-term asset allocators would also be looking at this metric. Further, their reasons to allocate more capital to India or redeem from it would be driven by internal issues, and not because prospects of some other countries in their benchmark changed.

Interestingly, the share of non-benchmarked investors among FPIs has also been rising over the past few years, making such comparisons even more inappropriate. Till August 2015, among the MFs/Broad-Based funds/ Investment Trusts, inflows though India-dedicated funds were also much higher than India flows from non-dedicated funds. However, given persistent disappointments by the Indian markets, in our view driven by the significant global linkages in the larger listed stocks, this reversed partly thereafter. This year, flows into India-dedicated funds have been in line with flows into other funds. Flows into India funds may start outperforming again as confidence in the sustainability of Indian economic momentum improves, and earnings visibility does too, but this is likely to be a slow multi-year process.

**Do FPI flows determine market moves? What next for FPI flows?**

If one plots the 12 month performance of an index like Nifty or MSCI India against the cumulative 12 month FPI Equity flows, the correlation since 1999 is just 0.4, i.e. it is statistically insignificant. The correlation was higher (0.66) in the 2003-10 period when markets were strongly trending and were also correlated to global trends: the bull run of 2003-07 followed by sharp declines in 2008, and then a strong revival in 2009-10. Trending markets are not analytically useful for this analysis as it is hard to separate cause from effect, i.e. were the price increases driving the flows or the flows driving the price increases? In one excludes this 7 year period, the correlation drops to just 0.25, and there are long periods of no visible correlation: for every year like 2012 (FPI inflows US$25bn, Nifty returned 29%), there is a 2013 (US$20bn, 6%), and for every 2016 (YTD US$3bn, 7%) there is a 2015 (US$3bn, -4%).

It is undeniable that over a very short term a surge in buying does move prices up, and a big seller brings prices down, but these effects don't seem to last long. In fact, the mental imagery of price increases driven by a horde of buyers screaming for stocks whereas the numerically fewer sellers act coy (or vice versa for a stock with a falling price) doesn't apply most of the time. Putting this into the context of FPI inflows/outflows, it isn't surprising to us that despite driving 40% of the trading volumes on many days despite heavy FPI buying/selling the market doesn't move up/down in the same direction.

Behind this are some deeper questions. The joke that never gets old among analysts is that when one is clueless about why a stock price moved up or down on a particular day, the best response to why the stock did what it did is "more buyers than sellers" (or vice versa). The funny bit of course is that (rightly or wrongly) analysts are expected to know reasons behind why there were more buyers or sellers on a particular day. But it also brings up a bigger question – what really sets price? Theoretically, for every buyer there is a seller, otherwise the trade doesn't conclude and the market price doesn't change. In fact prices can move up or down sharply without the trading volumes changing much.

What then drives prices? Earnings estimates for starters: we find a much stronger correlation between market movements and earnings estimates lagged six months. That is, markets start strengthening if index earnings growth is expected to start accelerating six months later. There are also changes in valuation benchmarks, in particular with record low bond yields globally. While P/E multiples for Indian indices have been higher than current levels only 4% of the time in the past, suggesting rich valuation vs. their own history, compared to the US 10 year bond yield, the most liquid asset class globally, the yield gap is still a high 4%, so it is relatively cheap.

Many traders, fund managers and analysts also believe that FPI money is "smart money". This may be true, given that many if not most FPIs have global assets to manage and are therefore better equipped and more experienced in terms of catching global trends. As the larger listed Indian stocks also have significant global business links, this should provide an advantage. However, as discussed in the first section, there are a number of different categories of FPIs, and attributing "smartness" to the whole group would be inappropriate. One measure of performance can be returns: it's rather remarkable that since its peak in January 2008 in dollar terms, the Nifty is still down 20%, and FPIs have ploughed in nearly $100bn since then.

Going forward, due to some structural changes in the global economy, it is quite possible that FPI inflows will not remain as strong as they were in the 2010-14 period, particularly with respect to the size of the market. This starts with the basic principle of economics that countries that have current account surpluses are also exporters of capital. In the last decade and a bit, oil exporters saw a rapid expansion of their current account surpluses. Most of these gains accrued with governments, and were invested as discussed earlier through relatively inexperienced SWFs in global markets: mostly bonds, real estate and equities. With the fall in oil prices, the surpluses have shifted to economies like China, Japan, Korea, Taiwan and Germany. These economies have technology as well as companies that can export capital: these are more likely to do so via FDI than through public markets.

That is not to say that FPI inflows will stall: in fact, contrary to the widely-held view that "most EM fund managers are overweight India, and so India will see outflows as they rebalance", we believe that the eventual pools of savings, i.e. pension/insurance/SW funds still have much lower India weights than targeted, and are likely to increase their India allocations. As India continues to emerge as an asset class (separate from the grouping with other EMs), a process slowed a bit (likely temporarily) by the disappointments last year, India's share of global markets is likely to rise.

We leave the reader with the following conclusions: 1) The FPI is not one monolithic entity, but many types of investors with very different investment horizons and mandates; 2) the assessment of whether FPIs are overweight or underweight India is best made at the level of the eventual saver, and not the intermediary EM fund managers that the markets generally analyse; 3) the most appropriate benchmark for Indian equities is global equities and not EM or NJA indices; 4) in the coming years FDI is likely to be the dominant form of capital inflows, and not FPI; and 5) even in the absence of large FPI flows, the markets may continue to do well.