Alpha generation in Indian equities is nota given, but seems possible

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<u>Global Equity Investing Landscape – Active versus Passive</u>

Over the past decade or so, globally there has been substantial rise of passive investment products in equities. The assets under management in Exchange Traded Funds (ETFs) and Index Funds have surpassed USD 5 trillion. Their success has fuelled heated and frequent debates about the future of active investing and whether active managers are able to deliver on their promises and justify their fees. There are many dimensions to this story. One that is often overlooked is the continuing growth of actively managed assets, albeit at a slower pace than passive investments, but still in the high single-digit/ low double-digit range. This may be explained in part by investors' continued strong interest in alpha generation, or investment outperformance. And so trust is placed in skilful managers who are able to achieve superior performance net of cost consistently.

The focus of Asset Management industry is to allocate capital efficiently for the growth of real economy and for the generation of wealth/ retirement income in the hands of investors. Protecting and enhancing clients' assets is the most honourable mission of asset management industry. But do the investors are best served if the funds simply beat a given benchmark net of fees? This is a fundamental question that has not been asked often enough within the industry or, more importantly, put to the investors. What counts over time in any industry is that it meets client expectations. And these expectations vary as much as the diverse group of clients the industry serves, ranging from those who have to match their liabilities in a very constrained regulatory environment through to individual investors that have a specific investment horizon and expect a determined outcome. Many would be happy with 200/ 300 basis points outperformance net of fees, if the underlying asset class has delivered positive returns (more so in a low positive return environment). But their esteem for alpha will be almost non-existent if they lose money and sight of achieving their investment targets.

Investment management, both active and passive, only generates value if it delivers against underlying expectations. Relative to understanding a client's core needs, looking at fund rankings and picking the funds with the best past performance could appear rather banal. Of course, it is important and takes skill to analyse the factors that are responsible for good relative performance and make a judgment on its consistency. But achieving a more meaningful difference for clients rests with firms' ability to be active in advice, since this is integral to making sure that they invest in an appropriate product or customised solutions. Many investment managers have understood this and invested in the quality of their client-facing people and the supporting infrastructure.

The results of various client surveys within asset management carried out from time-to-time show a strong correlation between excellent advisory capabilities and overall perception of quality and excellence according to clients. Traditional measures of alpha still have their place, but their limitations are all too apparent in the face of volatility and the investment challenges clients face. It is time to think of broader, more nuanced measures of alpha that reflect the value that can be added through genuinely consultative client relationships. Active investment managers should also be active in advice and view the quality of advice — delivered to clients directly or via intermediaries — as an integral part of their fiduciary duty on behalf of their clients.

<u>Indian Equity Mutual Fund Industry</u>

So far, in over more than two decades, the overall performance of Indian Equity Mutual Fund industry has been very strong when it comes to alpha generation. The Indian Equity Mutual Fund industry has created significant alpha in the last two decades, and that too on a quite consistent basis. However, the debate on whether the alpha generation will sustain going forward or not has been going on for a while now. Understandably, as markets become more institutionalised and assets under management swell, the concerns over ability of active portfolio managers to generate alpha assumes more significance.

At present, India with about 5,000 stocks has the highest number of domestic listed stocks in the world. Even if you assume that only 10% of these listed stocks are investible at any point of time, it is still a large universe. Similarly, India also presents vast diversity in terms of sectors that are represented by these stocks. There are a large number of sectors having reasonable breadth and depth to invest into- unlike the situation in many other markets in the world where only a couple of sectors dominate the economy and market.

In an under-institutionalised market, having such a vast and diverse listed stock universe is a significant opportunity for active fund managers to create alpha. Further, in an emerging economy like India, newer businesses and varied business models will continue to emerge – some of which may not be fully understood or discovered by all investors during initial phase. Most of these new listings will take time before they enter the benchmarks, which provides an opportunity for portfolio managers to create alpha. Going ahead, new emerging business models coupled with improved economy will continue to present enough opportunities to generate alpha through active portfolio management.

While the pool of investible opportunities may remain fairly large in India, alpha generation is not a given. Active portfolio managers will be able to outperform the market if they can make informed investment decisions based on their insights, knowledge, experience and ability to identify opportunities that can translate into superior performance.

We believe that a developing market like India still has many more years to go before saturation from a perspective of active fund management. However, as the time passes, no doubt, the alpha generation is unlikely to be as easy as in the past. Growing market efficiency will possibly reduce mispricing, thus limiting outperformance opportunities. Enhanced focus on investment research and institutionalization of the market will gradually make alpha generation more difficult, but hopefully not impossible.