



Under the Hood: What's in Your Index?

(An Ongoing Series, September 2015)

How to NOT Invest in the Dynamism of Emerging Markets: Through Your Emerging Markets ETF

Last month we reviewed how the flow of funds into an emerging markets high yield bond ETF, which is compelled to allocate new capital according to the country weightings of its strict rule set, can result in a 3.7% yield for 15-year Russian Federation bonds and 5.6% for 6-year Republic of Lebanon bonds—Lebanon! That's equivalent to saying that Lebanon is a full 1% point safer as to repayment of principal and interest than the consolidated breadth of the U.S. High Yield Corporate Bond index. ETF managers neither desire nor are permitted to make discretionary investment decisions based on valuation, no matter how bizarre, and the receipt of new funds can easily be of a magnitude that exceeds the ready supply of target investments. Ergo, this type of pricing.

One can readily see the confounding aspect of supply/demand in the bond market—how the very popularity of an investment will eventually defeat the promise it originally held. The same applies to stocks, of course, though stock valuations are far more debatable—one man's bubble is another man's growth stock. Nonetheless, let's try another asset allocation segment, such as emerging market equities. India, for instance, is of justifiable interest. Its population is poorer, larger, growing faster; it embodies all those and other desirable attributes. But see how, at least as practiced, indexation will fail its promise.

Among the world's stock markets, the Indian market is exceptionally broad and presents a perhaps unparalleled number of opportunities to participate in the economy's robust growth. Over 4,000 companies trade on its two exchanges. Most are quite small by U.S. standards; however, there are 765¹ with market values above \$100 million, and 490 companies—a virtual S&P 500—above \$250 million. Some are really quite cheap, growing rapidly, and will one day be far larger entities.

Stock Market Capitalization of the Indian Market (Dec. 2014)	No. Secs.
\$10 billion and greater	33
\$ 5 billion to \$10 bill.	33
\$1 billion to \$5 bill.	147
\$ 750 million to \$1 billion	55
\$500 million to \$750 million	75
\$250 million to \$500 million	157
\$100 million to \$250 million	275
\$100 million and under	<u>3,322</u>
	4,097

As to American participation, there are certainly many mutual funds and ETFs available. The four largest: the Wisdom Tree India Earnings Fund, which had \$2.54 billion of assets under management as of June 30, 2015; the iShares MSCI India ETF, with \$3.84 billion of AUM; and two broad emerging markets funds: the Vanguard FTSE Emerging Markets ETF and the iShares MSCI Emerging Markets. The latter two had \$78 billion of combined AUM as of June 30, of which they allocated \$8 billion to India. That's \$14 billion between these four funds alone, apart from institutions that index on their own. In 2014, according to the World Federation of Exchanges, the annual turnover at the two Indian exchanges was \$732 billion, or about \$3 billion per trading day. Here's a

provocative figure: the average daily turnover of these four ETFs (including only the India allocation for the two emerging markets ETFs) is over \$2 billion. There's not a lot of liquidity to share.

¹ As of December 2014.



Here's where supply and demand intersect in the context of indexation. The iShares MSCI India Index selection process, for instance, includes "companies whose market capitalization...represents the top 85% of companies in the Indian securities market." That sounds very inclusive, as if one is essentially buying exposure to the Indian economy. Let's look under the hood. There are actually very few Indian companies of significant market value in U.S. market terms: only 66 of the 4,000+ are worth more than \$5 billion, for instance. If all of the Indian companies above \$1 billion of market value were equally weighted, those 213 companies would represent, by rough estimate, only 5% of all the publicly traded Indian companies and very close to the 85% market value coverage that the iShares ETF selects for. So these India ETFs probably provide exposure to only several percent of the market by number of companies.

However, the ETFs are not equally weighted. Rather, they are assigned weightings in accordance with market value: the largest companies get the largest weightings. So the ETFs provide even less diversified exposure than the figures above suggest. Each of the all-India ETFs, the Wisdom Tree and iShares funds, are quite concentrated, with 44% and 52% of the assets in their top 10 holdings. The average market capitalization of those top 10 companies is about \$35 billion. Say what you will about a company with a \$35 billion market value, but one thing it is not is an emerging business, even if it is based in an emerging market. So the India ETFs don't really provide very much exposure to the emerging businesses of India.

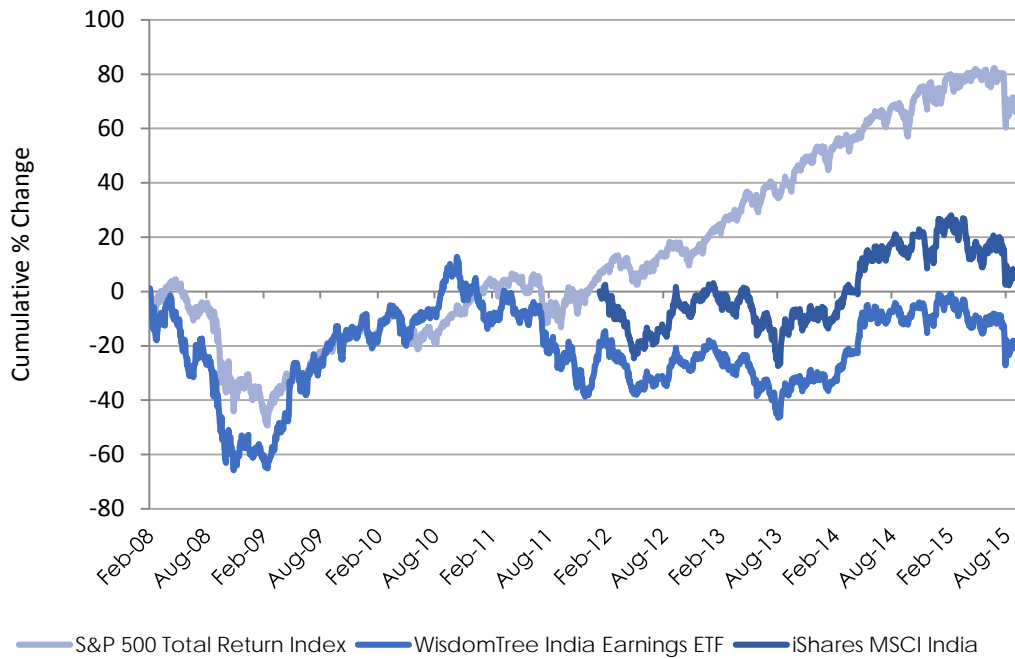
How about exposure to India itself? Three of the top four holdings in the iShares fund, equal to 22% of the assets, are: Infosys Limited, Tata Consultancy Services, and Reliance Industries. Three of the top five holdings of the Wisdom Tree fund, equal to 20% of the assets: are Infosys Limited, Tata Consultancy Services, and Reliance Industries. Infosys gets 98% of its revenues from outside India. Tata Consultancy gets 93% of its revenues from outside India. Reliance Industries gets 68%. So, there is not terribly much exposure to the emerging India economy, and not terribly much exposure to India.

There's also valuation as a consideration. These relatively few companies of sufficient stock market value and daily trading volume are in great demand, simply as raw material for inclusion in the index funds. That demand should be reflected in their share prices and valuations. For the three top-10 holdings cited above, their P/E ratios for expected earnings this year are: Infosys, 19.9x; Tata Consultancy, 21.0x; and Reliance Industries, 10x. Paradoxically, because these companies are actually multinational in terms of their growth prospects and profitability, it could be that their valuations are somewhat lower than the very small contingent of faster-growing companies that truly are exposed to the rapid expansion of the Indian economy. The 2nd largest holding in the iShares ETF and the 3rd largest in the Wisdom Tree ETF is Housing Development Finance Company, which has a \$29 billion market capitalization. Revenues are expected to be 16% higher this year. This year's expected P/E ratio is 26.6x.

That's the third problem: those relatively few Indian companies that do in fact derive their sales from India and are actually large enough to have the trading liquidity required by the indexes, are in such demand that they are priced exorbitantly. And that will diminish their ultimate share price returns. And it has already, as is evident in the long-term return charts for these indexes (from their inception dates of February 2, 2008 for the WisdomTree India Earnings Fund and February 2, 2012 for the iShares MSCI India ETF). They are either sharply negative or roughly flat during periods when the S&P 500 rose by 45%. During this period, the Indian economy, as measured by GDP, was expanding at a rate of about 9%, which was indeed fulfilling the emerging markets promise. This should not dissuade anyone from investing in India, for there are ways to participate in a manner consistent with the notion of local exposure, even in an index format, just not in the index structure currently in vogue.



Long-term Returns for Two India ETFs and the S&P 500 Index



Source: Bloomberg

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