Navigating the Herd Mentality in Indian Markets

Are foreign institutional investors considered "smart money"? Looking back, we see quite the opposite

15 Nov 2024 GQG Research

Key Takeaways

- Historical data reveals that periods of significant foreign investor outflows from Indian equities often precede strong relative market performance
- In our view, Indian companies, particularly in relatively under-owned sectors like infrastructure and utilities, continue to exhibit robust earnings growth
- Current pessimism in Indian equities may be a contrarian signal to buy rather than a reason to sell, offering potentially mispriced opportunities for discerning investors who focus on long-term value rather than short-term sentiment

In our view, investors have been overly concerned about India lately, for what we believe are the wrong reasons. These worries appear to mainly stem from weakening foreign investor sentiment on India alongside more positive views on China and the US, given recent stimulus in China and the US election results. There are fears that foreign investors may now take money out of India and deploy it in China or invest back into the US.

But now that the Chinese markets have given back more than half of the returns fueled by the stimulus optimism, the China-India narrative appears to have weakened, in our view.

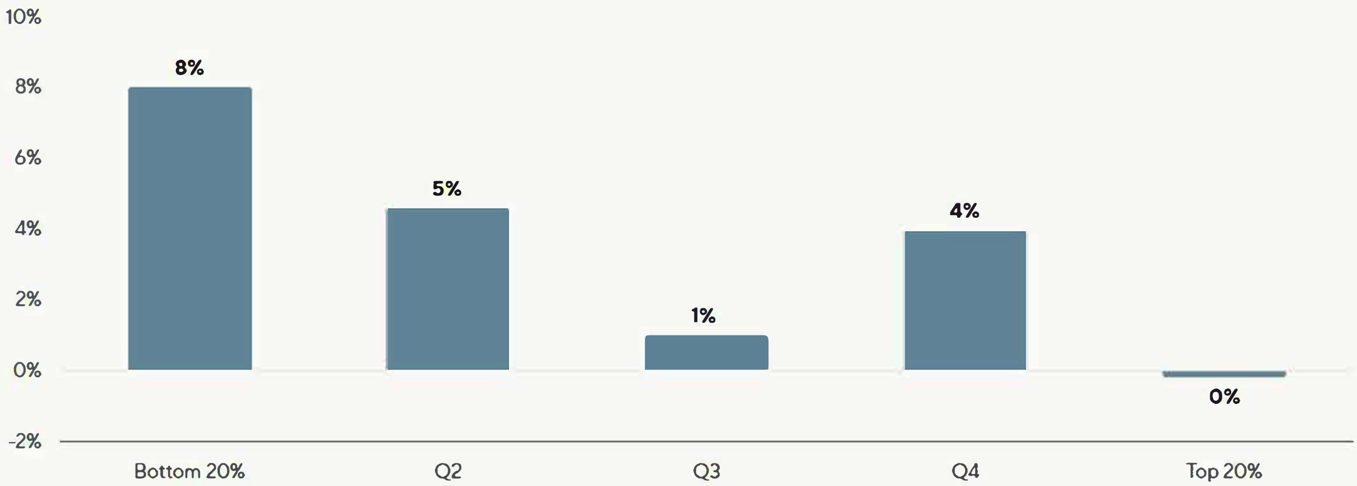
As fellow foreign investors ourselves, we view our cohort's behavior to sell, sadly, as a contrarian signal to buy. While past performance is not a reliable indicator of future performance, in the past, we have observed that some of the best times to buy Indian stocks have occurred when other foreigners were selling. For example, record outflows of foreign investor capital in 2022—including over $20 billion of outflows in secondary markets—set up a nice base for returns over the following 12 months.

We took a closer look at this phenomenon by comparing normalized net foreign investment into Indian equities on a monthly basis going back to 2005 (and then bucketed this measure into quintiles) versus the Indian stock market's median relative performance against broader emerging markets 12 months forward.

The chart below shows the return tendencies based on flow intensity—bottom 20% means the highest net outflows, top 20% highest net inflows over the period. The general pattern we observed is when high amounts of net foreign money flows into Indian equities, forward relative returns tend to be worse, statistically.

In this context, October 2024 was among India's largest monthly net outflows recorded by foreigners—while only a small piece of the puzzle, history suggests that may indicate better odds over the next 12 months.

India Median Forward 12 Month Excess Return by Net Monthly Foreign Investment Quintiles



Source: Bloomberg. Monthly data on net foreign equity investment into India is normalized versus trailing 3-month flow activity and then bucketed into quintiles.

WE BELIEVE INDIA IS A BRIGHT SPOT FOR EARNINGS GROWTH

In our view, Indian companies are poised to continue to deliver earnings growth. In fact, we go one step further: we think there are attractive mispriced opportunities in sectors where foreign institutional ownership is lower. For example, at the moment, we see lower-than-average foreign ownership in sectors such as infrastructure and utilities. These also tend to be sectors where domestic retail investors are active.

For those who are familiar with and understand our investing process and philosophy, none of this should sound new. We believe price follows earnings growth in the long run. A key part of our job as professional investors is to seek to pay reasonable valuations for this projected growth.

The NIFTY index has continued to deliver robust earnings growth at what we believe are reasonable valuations, as shown in the below chart of the NIFTY index versus the MSCI Emerging Markets and MSCI ACWI ex US indices. The NIFTY index has handily beaten the two broader indexes in terms of earnings growth over the last five years.

Despite the growth during this time period, valuations have been broadly stable, which seems to indicate that most of the performance generated by the NIFTY index was due to earnings growth in US dollar terms, not due to a re-rating of multiples.

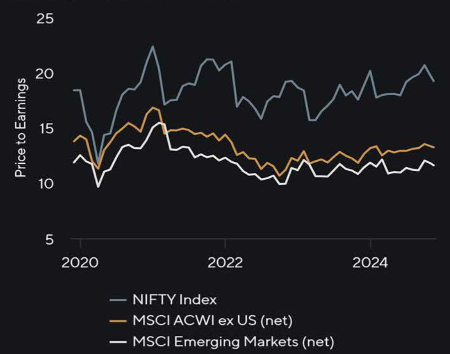
Some of the recent sell-side concerns may be due to recent quarterly growth not meeting expectations. We agree earnings growth versus expectations matter in the short run; however, in the long run, we believe it is the absolute percentage growth of earnings that matter.

NIFTY Index versus MSCI Emerging Markets and MSCI ACWI ex US Indices

NIFTY Delivered Faster Earnings Growth

Source: Bloomberg. Normalized cumulative percentage growth in USD Earnings Per Share. For the time period November 29, 2019 through November 15, 2024. You cannot invest directly in an Index. Past performance may not be an indicator of future results.

Broadly Stable Valuations



Source: Bloomberg. Price to FY1 Earnings. For the time period November 29, 2019 through November 15, 2024. You cannot invest directly in an Index. Past performance may not be an indicator of future results.

Performance Due to Earnings Growth

Source: Bloomberg. For the time period November 29, 2019 through November 15, 2024. You cannot invest directly in an Index. Past performance may not be an indicator of future results.

PRIMARY LISTINGS LIKELY EXACERBATED SOME OF THE MOVES

There are some additional tactical challenges in the Indian market. It appears that new issuances have soaked up liquidity, especially among foreign investors, with the year-to-date inflows exceeding $11 billion in the primary market. This influx might have contributed to the $14 billion of outflows from the secondary market in 2024.

FPIs Flows into Primary and Secondary Market

Calendar Year Ends 2014-2024 (US$ bn)

Source: Prime Database. Kotak Institutional Enterprises.

Overall, we believe India's macro remains favorable, based on GDP growth prospects and a positive fiscal outlook and attractive longer term demographic trends. In our view, the long-term benefits of reforms undertaken in the past decade are underappreciated. These reforms include laws intended to facilitate quick resolution of bankruptcy and improve accountability in real estate projects. Also, India may be one of the few major countries that continues to simplify its taxation system.

FOLLOW THE EARNINGS GROWTH

We continue to favor businesses with strong earnings growth—specifically we view infrastructure and utilities companies offering attractive growth prospects at reasonable valuations with the comfort of long-term contracts.

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The **MSCI Emerging Markets Index** captures large and mid cap representation across 24 Emerging Markets countries. With 1,437 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

The **MSCI ACWI ex USA Index** captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 24 Emerging Markets countries*. With 2,094 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

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