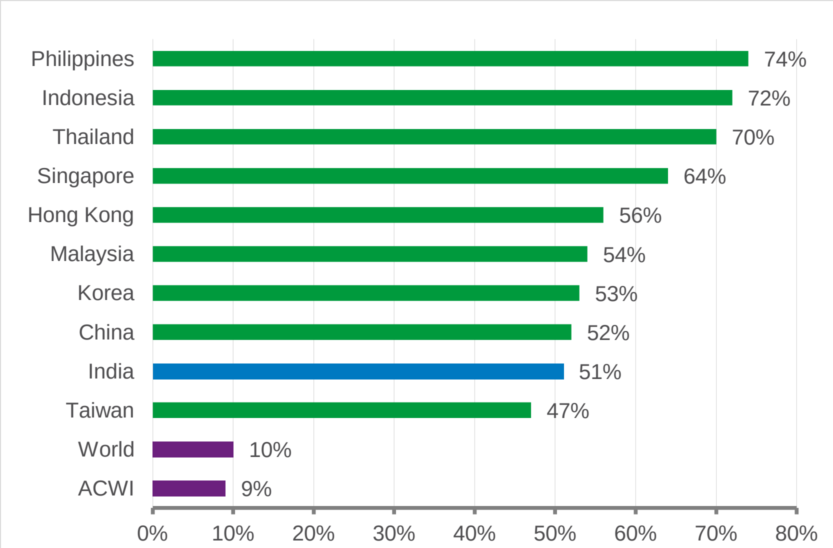
What is the role of international assets in domestic investor portfolios?

21 August 2013

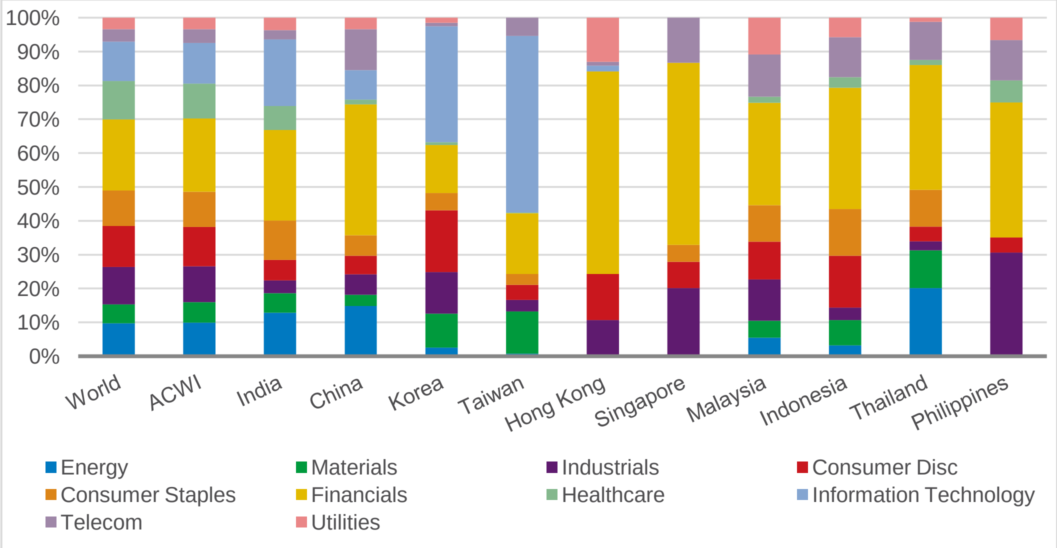
Home bias issue: High stock and sector concentrations

Top 10 stocks as % of total market



Source: FactSet

Sector market cap as % of total market



Source: MSCI, as of July 31, 2013

Indian equity market is dominated by its largest sectors and stocks

- The 10 largest stocks account for 51% of India's market cap
  - For other Asian ex-Japan country markets, it is between 45% and 75% of their market caps
- Financials and technology account for almost half of India's market cap
- Global indices like MSCI World (DM) and MSCI ACWI (DM + EM), are more well diversified with ~30-33% exposure to top 2 sectors

International equity indices are more diversified compared to individual markets

Home bias issue: Less diversification leads to higher volatility

Annual volatility of equity benchmarks in Asia ex-Japan vs. global benchmarks

Source: MSCI, as of Dec 31, 2012. Based on monthly local currency returns.

Higher stock & sector concentration leads to higher volatility, which increases downside risk

Global asset allocation improves return/risk profile

	Changes in risk			Changes in return/risk		
	75% Local 25% ACWI	50% Local 50% ACWI	25% Local 75% ACWI	75% Local 25% ACWI	50% Local 50% ACWI	25% Local 75% ACWI
India	**-18%**	**-35%**	**-48%**	**7%**	**14%**	**18%**
Hong Kong	-16%	-30%	-41%	3%	6%	6%
Korea	-25%	-39%	-34%	28%	49%	30%
Singapore	-15%	-29%	-39%	6%	11%	13%
Taiwan	-16%	-30%	-40%	15%	33%	52%
China	-18%	-34%	-47%	29%	70%	123%
Indonesia	-25%	-39%	-34%	32%	61%	49%
Malaysia	-21%	-35%	-35%	23%	43%	37%
Philippines	-20%	-36%	-47%	14%	30%	40%
Thailand	-23%	-39%	-45%	22%	47%	50%

Source: MSCI – The Next Generation of Global Investors, July 2013 | Data is for period from 1990 - 2010

Adding 25% international equities to an Indian equity portfolio reduces risk by 18% & improves return/risk ratio by 7%

International assets could help buffer the effect of market cycles

INR performance of various BlackRock funds

		2007	2008	2009	2010	2011	2012	YTD2013
Thematic	Gold Equity	19.00%	-19.00%	41.90%	30.60%	-2.50%	-5.20%	-31.90%
	Mining Equity	42.10%	-55.70%	94.90%	24.10%	-15.30%	0.00%	-21.50%
	Energy Equity	24.80%	-33.80%	30.30%	12.20%	2.80%	-4.80%	23.00%
	Agriculture Equity	NA	NA	NA	NA	2.10%	14.50%	9.40%
	New/Alternative Energy Equity	39.40%	-43.30%	15.60%	-16.20%	-6.80%	7.10%	27.00%
Regional	US Equity	-5.70%	-25.50%	17.90%	3.20%	18.60%	13.70%	33.30%
	Japan Equity	-20.40%	-20.60%	-4.60%	10.80%	-4.70%	11.20%	29.20%
	China Equity	NA	NA	71.40%	3.60%	-6.20%	26.90%	0.80%
	Latin America Equity	25.60%	-44.60%	110.90%	12.50%	-9.40%	8.90%	-6.10%
	Emerging Europe Equity	17.70%	-62.40%	83.10%	15.00%	-13.50%	24.30%	4.60%
	Global Equity	5.90%	-20.50%	22.80%	6.30%	9.40%	15.00%	26.50%
	Global Asset Allocation	2.60%	-4.80%	16.80%	4.30%	13.70%	11.40%	19.60%
Domestic	Average Diversified Indian Equity Fund	61.40%	-56.02%	85.73%	17.28%	-22.86%	31.78%	-10.20%
	Nifty Index	**54.80%**	**-51.80%**	**75.80%**	**17.90%**	**-24.60%**	**27.70%**	**-2.80%**
	USD returns (vs. INR)	**-11.0%**	**23.8%**	**-4.7%**	**-3.9%**	**18.7%**	**3.6%**	**9.8%**

Source: Bloomberg, Internal; as at 31 July 2013

Different themes & regions react differently to market cycles, thereby offering diversification potential

The benefits of currency diversification

Correlation Matrix

	US Dollar	Euro	British Pound
Nifty	**-0.58**	-0.09	-0.23
Sensex	**-0.58**	-0.11	-0.22
CNX Mid-Cap	**-0.56**	-0.04	-0.19
BSE Small Cap	**-0.50**	-0.02	-0.12
CNX 500	**-0.57**	-0.09	-0.22

Source: Bloomberg, as of June 30, 2013

Negative correlation of USD with domestic equity makes strong case for diversification

Look at currency exposure of international assets, not as a risk, but as a key diversification element in the portfolio

Why investors are wary about investing offshore?

Expectations of higher returns is one of the key reasons for home bias

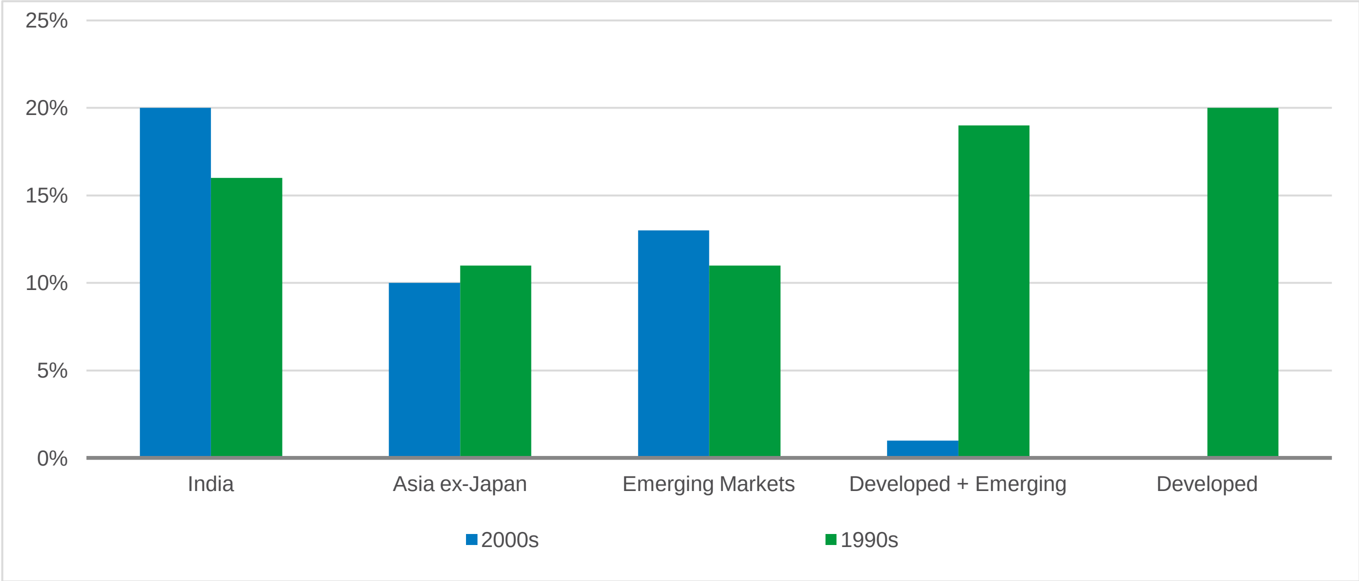
Indian investors typically have a preference to domestic equities due to higher return expectations

- Driven by the expectations of continued superior long-term future economic growth

Historical evidence has been supportive

- Faster economic growth and stronger equity performance over past 10 years

Indian equities have outperformed regional and global benchmarks in the last decade (Average 1 year rolling returns in INR terms)



Source: MSCI; 1990s data starts from 31 Dec 1992

Other common factors driving home bias

Tax considerations

- Favourable tax treatment of domestic investments

Currency risk and cost of hedging

- Investors may be reluctant to invest globally due to currency risk exposure
- In the context of equity allocations, impact of currency risk is unlikely to be as significant as equity risk
- Currency hedging is not commonly undertaken by retail investors

Familiarity & local information advantage

- Greater confidence in understanding local market dynamics compared to offshore investments

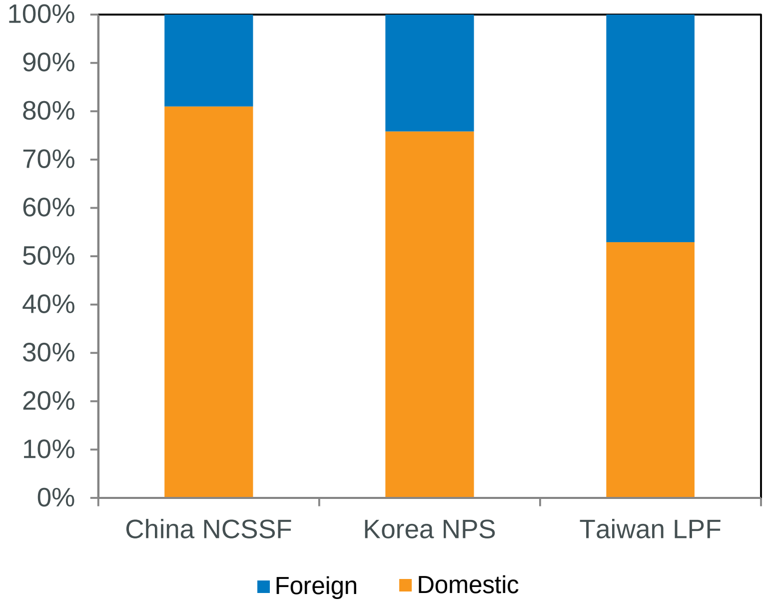
Liability considerations

- Most Indian investors do not have any foreign liabilities or linkages necessitating a separate savings pool
- This is increasingly changing though – children being sent abroad for higher studies, investing in real estate for children settled abroad, etc.

With globalisation, a lot of these factors causing home bias should not matter anymore

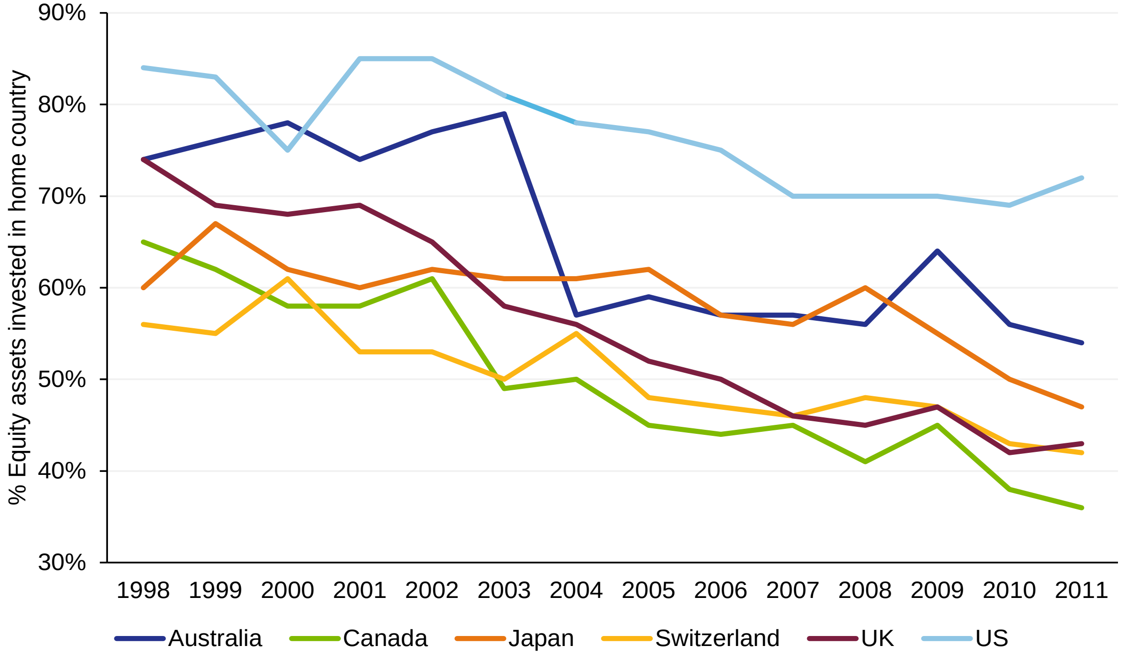
Indian investors are not alone in exhibiting strong home bias

Even large Asian Pension Funds are predominantly invested in domestic assets…



Source: Cerulli, BlackRock

…but over the years many large institutional investors are increasingly diversifying away from their home countries



Source: Towers Watson

Major institutional investors have now realised the importance of having geographically diversified portfolios

How do you add international exposure?

Process for building global portfolio exposure

1. Process for choosing appropriate investments/vehicles
    - Global Scale and expertise of the Fund Manager
    - Local Geographic presence and expertise
    - Experience of team in handling similar Portfolios
    - Performance track record of the Products offered
    - Global third party recognition and recommendations for the product

2. Investment Product categories for building Global Portfolio Exposure
    - One Stop Shop – Global Allocation Fund (stocks, bonds, cash)
    - Global All-Cap Equity Manager
    - Regional/Thematic Funds
    - Passive Country/Region specific ETFs

How a professional manager like BlackRock can help

1. Access to global investment opportunities across asset classes, regions, sectors and currencies
2. Help understand and manage risks to global/international investing
3. Keep investors regularly updated through quarterly calls with portfolio managers, as well as monthly portfolio updates
4. Provide access to latest viewpoints & research from BlackRock Investment Institute

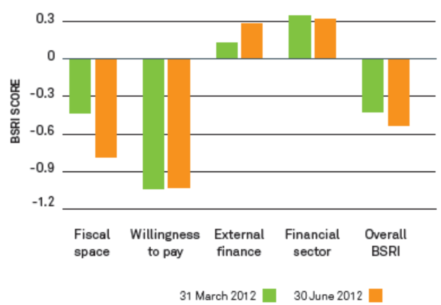
Exit, Entry and Overshoot: 2013 Outlook Midyear Update (June 2013)

Scenarios Reset

SCENARIO	DESCRIPTION	ODDS	
Age of Separatism 40% (Up 5%)	Increasing divergence between economic growth, policy moves and financial market returns (between and within asset classes, countries, industry sectors and individual securities).	We have updated this scenario to capture growing global policy divergence (the US Federal Reserve's reining in bond purchases versus the Bank of Japan's starting a $1 trillion-plus asset buying programme).	Equitie less ris incom Relativ and se Shift g incom assets growth
Stop 'N Go 25% (Down 5%)	On-and-off growth spurts in the United States and emerging world. Europe veers in and out of recession and Japan proves another false dawn. Bank delevering dampens growth and risk taking.	Investors mostly forgot about this risk-on/risk-off scenario in 2013 – until June brought back bad memories of the summers of 2011 and 2012. Thanks for the reality check!	Correla rallies Super long-t The hu divider yield a Defens
Nemesis Redux 15% (Up 5%)	The prospect of a global recession, deflation or credit crunch (or all of the above) triggers steep losses across asset classes. Named after	Risks have increased and broadened: A panic on fears the Fed is taking its foot off the gas too quickly. A rapid rise in real	The us cash, U Germa Japane and go Investr should

BlackRock Sovereign Risk Index Quarterly Report (July 2012)

INDIA: THE ELEPHANT STUMBLES



Source: BlackRock

India faces declining growth, gaping fiscal deficits and capital flight, as we detailed in 'When the Elephant Gets Sick: India at a Crossroads' in June 2012. This confluence of factors has hurt India's BSRI profile, with its Fiscal Space score suffering from increased general government debt, diminished access to capital markets and lower GDP growth forecasts. See the chart on the previous page. India has deteriorated steadily since the fourth quarter of 2011.

Investing in Emerging Markets (April 2013)

- **Beware Fake Goods:** Emerging market exposures come in many guises. Carefully examine the goods before purchase.
- **Warning Flags:** Steer away from countries and assets that rely on external funding or show signs of excessive credit growth.
- **Next Frontier:** Frontier markets offer compelling stock valuations, comparatively high bond yields and low volatility ... but few investable assets.

Debt (details on pages 12–14)

- **Relative Value:** Emerging market bonds offer relatively high yields in the zero rate world—but it will be tough to replicate the double-digit returns of the past.
- **Captive Demand:** Explosive growth in emerging market pension assets underpins structural demand for emerging debt.
- **Big Is Beautiful:** Emerging debt markets have jumped in size, credit quality and diversity. This means more opportunities to separate the wheat from the chaff.

Equities (details on pages 15–16)

- **Cash Is King:** We like companies that derive a large proportion of their cash flow from emerging markets—wherever they may be listed. If they increase dividends, all the better.
- **Travel Destinations:** Brazilian and Russian stocks look like good value after underperformance. We would avoid the Mexican and Shanghai bourses for now.
- **Foodies Welcome:** Increased global demand for food bodes well for companies specializing in agricultural equipment, food science and logistics.

Role of Advisor is critical

Active management of international exposure required

- Educate client on benefits and risks to global/international investing
- Actively use internal and external research to identify the right themes and regions to invest in
- Rebalance allocations

Investors need active advisory support to keep pace with changing global opportunities

What opportunities are available now?

The global investment environment

Views from BlackRock Investment Institute

- Global monetary policy is diverging and the era of easy money is slowly ending; brace for more volatility
- Policy will continue to be a key force in determining investment returns
  - The Fed has sketched out a plan for gradual QE withdrawal but made clear the pace depends on economic data
  - The Bank of Japan (BoJ), by contrast, is making a new entry in the QE game
  - The European central Bank (ECB) is standing by for now

US	▸ The US economy is pretty fragile and the Fed appears ready to give it a helping hand when needed ▸ The US budget deficit is falling thanks to spending cuts and rising tax revenues. This is a medium-term trend ▸ A comprehensive budget deal is needed to arrest the deficit situation
Eurozone	▸ We do not expect ECB President Mario Draghi to make any big moves to spur lending ▸ Growth remains sluggish, but Europe looks poised to emerge from recession as it moderates austerity measures ▸ Europe needs growth (preferably triggered by labour market reforms) to turn the corner
Japan	▸ Fiscal stimulus alone cannot save Japan, but it can act as life support ▸ So far, foreign investors have been the most enthused by the BoJ’s actions ▸ Structural reforms will be essential for Japan to reverse two decades of sluggish growth and deflation
Emerging Markets	▸ Emerging market growth will continue to outpace developed market growth ▸ Weak currencies could stoke inflation and raise the risk of a credit crunch in countries relying on external funding ▸ The prospect of the end of easy money and rising real interest rates in the developed world could make emerging market assets less attractive

Structural investment themes to think about

US Shale Boom	▸ The oil and gas industry has accounted for 20-30% of US growth in fixed asset investment and industrial production over the last few years ▸ Low cost producers of oil and gas, service and technology providers, select refining assets, and the infrastructure, petrochemicals, fertiliser and steel sectors would be beneficiaries
Agriculture	▸ Increasing populations, urbanization, growing incomes and changing diets in the emerging world represent structural demand for food. ▸ This should benefit agricultural equipment and logistics as well as seed and crop science. ▸ Water resources are being depleted, putting a premium on water technologies.
Energy	▸ Demand for energy, as emerging countries continue to require it to support their growing infrastructure and automobile purchases. ▸ Non-OECD countries currently make up less than 50% of global oil demand but should provide almost all expected demand growth
Alternative energy	▸ Falling equipment prices have made renewable energy increasingly cost competitive with traditional fossil fuels
Healthcare	▸ Rising demand for healthcare in the emerging world due to an increase in GDP per capita.
Industrial automation	▸ Tendency toward industrial automation. For example, increasing wage levels and slowing productivity growth in China drive demand for greater industrial automation.

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Annexure

What lies ahead?

ASSET		POLICY PRICED IN	ALTERNATIVE POLICY PATH	IMPACT ON ASSET
DM STOCKS	United States	Fed starts reducing bond purchases by year end	Fed "tapering" is sooner or bigger	Downside ▼
DM STOCKS	Japan	BoJ is "all-in" on QE; government provides some fiscal stimulus	Less fiscal stimulus than expected	Downside ▼
			More fiscal stimulus; labour reforms and deregulation.	Big Upside ▲
DM STOCKS	Eurozone	ECB muddles through; cuts discount rate	Eurozone resolution through banking union, some debt mutualisation	Big Upside ▲
			ECB's programme of Outright Monetary Transactions (OMT) is tested – and fails	Big Downside ▼
EM STOCKS	Emerging Markets	Imminent Fed tapering; No China stimulus	Fed tapering is slower and smaller; China launches stimulus.	Big Upside ▲
			Fed tapering triggers full-blown funding crisis	Big Downside ▼
BONDS	US Short-Term Rates	Fed tapering and rate rises	Fed tapering is slower and smaller; rate rises are further away	Upside ▲
BONDS	Emerging Market Debt	Imminent Fed tapering; no China stimulus	Tapering slower and smaller	Upside ▲
			China launches stimulus	Upside ▲
COMMODITIES AND CURRENCIES	Industrial Metals	China slows; no stimulus	China launches stimulus	Upside ▲
COMMODITIES AND CURRENCIES	Euro	ECB muddles through	ECB goes all-in	Bon voyage, Euro ▼
			OMT fails	Farewell, Euro! ▼
COMMODITIES AND CURRENCIES	US Dollar	Fed tapers this year	Policy uncertainty intensifies	Upside ▲
COMMODITIES AND CURRENCIES	UK Sterling	UK needs more stimulus	More stimulus unnecessary	Upside ▲