Design and Implementation of Multi-asset Funds in India

By

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ABSTRACT
India, over the past decade, has steadily emerged as a center of attractive investment opportunities, owing to high GDP growth rates and rising levels of per capita income. Asset management in India is going through a steady metamorphosis with rapidly growing AUM attributable to an influx of foreign investment and a steadily increasing investable surplus, albeit in the face of changing regulation. Although valuations have increased at a rapid rate, investors have been weary of high volatility and are seeking investment products that focus on risk-adjusted returns. Multi-asset investment funds are gaining prominence worldwide as they offer the benefits of diversification, while enabling exposure to an array of asset classes. The market for alternative investment products in India is at a nascent stage, offering tremendous potential for fund managers who can not only cater to the risk and return needs of investors, but also provide innovative and novel solutions that extend beyond the prevalent homogenous product mix to a target market in which investor literacy is progressively increasing.

This thesis provides a background of the Indian capital markets, specifically the Asset Management Industry, to determine the key value drivers that are imperative to success and leadership in the future. A segmentation of the market is conducted to offer targeted distribution and marketing in an otherwise diverse and broad market. An analysis of the risk and return metrics of asset classes has been performed to devise model portfolios that illustrate the value added of multi-asset funds. The study also provides competitive strategies for fund managers seeking to establish and grow their business in India.

Thesis Supervisor: S.P. Kothari
Title: Deputy Dean and Gordon Y. Billard Professor of Management
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# Table of Contents

List of Figures................................................................................................................................................... 7  
List of Tables....................................................................................................................................................... 7  

1. Introduction................................................................................................................................................... 10  
2. Objectives ................................................................................................................................................... 11  
3. Methodology................................................................................................................................................ 13  
  3.1 Background research ................................................................................................................................. 13  
  3.2 Data acquisition, analysis and design ........................................................................................................ 14  
  3.3 Market segmentation and competitive strategy ......................................................................................... 15  
4. Country Analysis........................................................................................................................................... 16  
  4.1 Background .............................................................................................................................................. 16  
  4.2 Economic climate .................................................................................................................................... 17  
5. Regulation..................................................................................................................................................... 21  
  5.1 Domestic financial markets regulation .................................................................................................. 21  
  5.2 Overseas investment regulation .............................................................................................................. 21  
      5.2.1 Institutional investment overseas .................................................................................................... 21  
      5.2.2 Individual investment overseas ..................................................................................................... 22  
  5.3 Foreign institutional investor regulation ............................................................................................... 22  
6. The Asset Management industry................................................................................................................. 23  
  6.1 Competitive environment ....................................................................................................................... 23  
  6.2 Profitability ................................................................................................................................................ 26  
  6.3 Market penetration .................................................................................................................................. 28  
  6.4 Distribution .............................................................................................................................................. 30  
      6.4.1 Banks .............................................................................................................................................. 30  
      6.4.2 Independent Financial Advisors .................................................................................................... 31  
      6.4.3 Direct Sales .................................................................................................................................... 31  
  6.5 Hedge funds in India .............................................................................................................................. 32  
7. Major asset classes in India.......................................................................................................................... 35  
  7.1 Direct Equity .......................................................................................................................................... 35  
  7.2 Insurance .................................................................................................................................................. 36  
  7.3 Fixed deposits .......................................................................................................................................... 38  
  7.4 Provident fund ........................................................................................................................................ 39  
  7.5 Mutual funds .......................................................................................................................................... 39  
  7.6 Real estate ............................................................................................................................................... 41  
  7.7 Private equity .......................................................................................................................................... 41  
  7.8 Commodities .......................................................................................................................................... 42  
8. Target market................................................................................................................................................. 43  
  8.1 Investor classification ................................................................................................................................. 43  
      8.1.1 Individual investors .......................................................................................................................... 43  
      8.1.1.1 Retail investors ............................................................................................................................ 44  
      8.1.1.2 High net worth individuals .......................................................................................................... 45  
      8.1.2 Institutional investors ...................................................................................................................... 48  
      8.1.2.1 Foreign institutional investors ................................................................................................... 49  
      8.1.2.2 Domestic institutional investors ............................................................................................... 52  
  8.2 Segmentation by income group ............................................................................................................... 53  
  8.3 Segmentation by geographic location .................................................................................................... 54  

7
9. Multi-asset funds.......................................................................................................................................... 55
  9.1 Introduction to multi-asset investing................................................................................................ 55
  9.2 Performance metrics............................................................................................................................. 55
  9.3 Multi-asset funds in India................................................................................................................... 57
10. Selected asset classes for multi-asset funds............................................................................................ 60
  10.1 Benchmark............................................................................................................................................ 60
  10.2 Equity.................................................................................................................................................... 61
  10.3 Real estate............................................................................................................................................. 63
  10.4 Commodities........................................................................................................................................ 64
  10.5 Hedge Funds......................................................................................................................................... 65
  10.6 Treasuries.............................................................................................................................................. 67
  10.7 Comparison of risk/return metrics................................................................................................... 68
11. Portfolio allocation...................................................................................................................................... 72
12. Competitive strategy................................................................................................................................... 79
13. Conclusion.................................................................................................................................................... 85
References............................................................................................................................................................ 86
List of Figures

<table>
<thead>
<tr>
<th>Figure No.</th>
<th>Figure Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1</td>
<td>India's Gross Domestic Product</td>
</tr>
<tr>
<td>4.2</td>
<td>Bombay Stock Exchange Market Capitalization (% of GDP)</td>
</tr>
<tr>
<td>4.3</td>
<td>GDP Contributors</td>
</tr>
<tr>
<td>4.4</td>
<td>Inflation</td>
</tr>
<tr>
<td>6.1</td>
<td>No. of Asset Management Companies in India</td>
</tr>
<tr>
<td>6.2</td>
<td>Average AUM (in USD billion)</td>
</tr>
<tr>
<td>6.3</td>
<td>Asset Management Industry Profitability</td>
</tr>
<tr>
<td>6.4</td>
<td>AMC Market Penetration</td>
</tr>
<tr>
<td>6.5</td>
<td>Segmented AUM of asset Management Companies (in USD billion)</td>
</tr>
<tr>
<td>6.6</td>
<td>AMC Distribution Channels</td>
</tr>
<tr>
<td>6.7</td>
<td>Eurekahedge India Hedge Fund Index (All Strategies)</td>
</tr>
<tr>
<td>6.8</td>
<td>Comparative Performance of Indian Hedge Fund Strategies</td>
</tr>
<tr>
<td>7.1</td>
<td>Breakdown of Direct Equity Investments</td>
</tr>
<tr>
<td>7.2</td>
<td>Market Cap of BSE and NSE (in USD billion)</td>
</tr>
<tr>
<td>7.3</td>
<td>Breakdown of Insurance Assets</td>
</tr>
<tr>
<td>7.4</td>
<td>Life Insurance Investments</td>
</tr>
<tr>
<td>7.5</td>
<td>Bank Deposit Interest Rates</td>
</tr>
<tr>
<td>7.6</td>
<td>Mutual Fund Investments</td>
</tr>
<tr>
<td>7.7</td>
<td>Mutual Funds Percentage Share in Household Savings</td>
</tr>
<tr>
<td>7.8</td>
<td>BSE Realty Index</td>
</tr>
<tr>
<td>7.9</td>
<td>Private Equity Investment in Indian SMEs</td>
</tr>
<tr>
<td>8.1</td>
<td>Distribution of Individual wealth in India</td>
</tr>
<tr>
<td>8.2</td>
<td>Composition of Household savings</td>
</tr>
<tr>
<td>8.3</td>
<td>Indian HNI Growth (in thousands)</td>
</tr>
<tr>
<td>8.4</td>
<td>Asia-Pacific HNI Wealth Distribution in 2009 (in USD million)</td>
</tr>
<tr>
<td>8.5</td>
<td>HNI Wealth Distribution</td>
</tr>
<tr>
<td>8.6</td>
<td>Foreign Institutional Investment</td>
</tr>
<tr>
<td>8.7</td>
<td>Secondary Market Purchases by FIIs vs. No. of Registered FIIs</td>
</tr>
</tbody>
</table>
Sources of Foreign Institutional Investment in India

Distribution of Population by Income Group

Evolving Asset Allocation

BSE Sensex (Jan 2006 - Mar 2011)

NSE S&P CNX Nifty (Jan 2006 - Mar 2011)

NSE Nifty Cumulative vs. Monthly Returns

BSE Realty Index (Jan 2006 - Mar 2011)

BSE Realty Index Cumulative vs. Monthly Returns

MCX Comdex (Jan 2006 - Mar 2011)

MCX Comdex Cumulative vs. Monthly Returns

Eurekahedge India Hedge Fund Index (Jan 2006 - Mar 2011)

Eurekahedge India Index Cumulative vs. Monthly Returns

91-day T-bill Yield % (Jan 2006 - Mar 2011)

Risk/Return of Selected Asset Classes

Daily Return Volatility of Major Stock Indices

AMC Resource Mobilization and Stock Market Volatility

Graphical Representation of the OCRA

Cumulative Returns of Multi-asset Portfolio vs. Benchmark

Optimal Portfolio Risk/Reward Line

Value Proposition of Multi-asset Funds

Four Actions Framework

Hierarchy of Investor Preferences
# List of Tables

<table>
<thead>
<tr>
<th>Table No.</th>
<th>Table Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1</td>
<td>Financial Markets Regulatory Authorities</td>
</tr>
<tr>
<td>6.1</td>
<td>Largest Asset Management Companies in India</td>
</tr>
<tr>
<td>6.2</td>
<td>Fund Offerings by AMCs</td>
</tr>
<tr>
<td>6.3</td>
<td>Performance Metrics of Indian Hedge Funds</td>
</tr>
<tr>
<td>8.1</td>
<td>Investment Preferences of Income Groups</td>
</tr>
<tr>
<td>9.1</td>
<td>Performance Metrics of Global Hedge Funds by Strategy</td>
</tr>
<tr>
<td>9.2</td>
<td>Multi-asset Funds in India</td>
</tr>
<tr>
<td>10.1</td>
<td>Key Statistics of Selected Asset Classes</td>
</tr>
<tr>
<td>10.2</td>
<td>Correlation Matrix</td>
</tr>
<tr>
<td>11.1</td>
<td>Key Statistics for the Optimal Portfolio (without correlation)</td>
</tr>
<tr>
<td>11.2</td>
<td>Key Statistics for the Optimal Portfolio (with correlation)</td>
</tr>
</tbody>
</table>
1. Introduction

Twenty years after liberalization, India today stands amidst the fastest growing economies of the world, supported by a rapidly growing services sector and rising export levels. India’s growth story has not only caught the eye of investors worldwide, but also financial service providers who are eagerly seeking to deploy resources to gain competitive advantage through servicing the investment needs of an enormously large populace with a rapidly growing investable surplus. The tremendous potential to provide investment solutions to India’s individual and institutional investor segments is further underscored by the prevalent low levels of participation in the capital markets due to a history of high volatility and stock market scams.

India’s Asset management industry is transforming itself to adapt to the dynamically changing landscape of regulation and evolving client mandates. While on the one hand, there is a concerted effort by policy makers to make progressive shifts toward further liberalization, on the other, the economy is recovering from the global financial crisis. Risk-adjusted returns are the need of the hour and improving investor literacy has compelled asset management companies to rethink their product offerings from primarily equity and fixed-income strategies, to incorporate innovative solutions in order to be able to compete on product, and not on the traditional distribution and marketing.

Multi-asset funds have seen increasing demand worldwide over the past few years as investors look for solutions that provide diversification and the opportunity to capitalize on price increases across different asset classes. The Indian asset management landscape provides opportunities for multi-asset fund managers to introduce such products by catering to not only the risk and return needs of investors, but also the idiosyncrasies of a country that places high value on the attributes of trust and transparency. Now is the time to gain an early mover advantage through providing optimal solutions in the multi-asset class by devising a competitive strategy that will allow for product innovation and targeted distribution.
2. Objectives

This paper seeks to answer three questions. What is the landscape of the Indian Capital Markets, specifically the Asset Management industry? What is the market for Multi-asset funds in India? What are the best implementation strategies for Multi-asset investment products in India?

Answering these questions firstly requires a comprehensive analysis of the Indian capital markets. Section 4 provides a historical perspective and the current economic climate to give a better understanding of why India is a favored destination for financial service providers. While the key economic indicators and growth projections are important to understand the country’s attractiveness, it is also important to understand the regulatory policies in effect. Section 5 details the country’s regulators and key policies that drive investments within the country and overseas.

Section 6 provides a detailed analysis of the Asset Management industry in India and its intrinsic characteristics, namely the competitive environment, profitability, market penetration and distribution. To understand the market for multi-asset funds and develop suitable strategies to enter the market, it is important to look at the country’s Hedge Fund industry to fully weigh the possible options to create market space. Section 6 extends the Asset Management landscape to the Indian Hedge Fund industry to provide an analysis of the performance of strategies employed. Before designing products for the Indian market, it is necessary to analyze the current investment options available in the country. The purpose of section 9, which details the available asset classes, is not only to provide information on these asset classes and their popularity among Indian investors, but also to understand the possible mix that can be included in multi-asset products. Section 8 offers a segmentation of the market based on investor categorization, income groups and geographic location to enable focused marketing and distribution for each class of investors to be targeted.

Section 9 makes the case for multi-asset funds and their growing need in the current investment climate. It provides an analysis of the prevailing multi-asset funds in India, in both the Asset Management and Hedge Fund space. The section then looks at the possible market for multi-asset funds in India, including size and growth projections.
Designing new products requires an understanding of the expectations of Indian investors pertaining to risk and return. An analysis of the prevailing risk/return characteristics in section 10 sets forth the parameters to be targeted for new product offerings.

After gaining an understanding of the market and characteristics of asset classes, section 11 attempts to design a model optimal multi-asset portfolio, illustrating its value added over not just the benchmark, but also all other asset classes. The five asset classes included are Equity, Real Estate, Commodities, Hedge Funds and Treasuries. Finally, section 12 presents competitive strategies to gain market share for multi-asset products and fund managers seeking to establish and grow their business in the Indian asset management landscape.
3. Methodology

To answer the questions posed in the project objectives, the methodology used in this paper is categorized into three distinct segments. An in-depth understanding of the target market is necessary to determine the characteristics that are intrinsic to the Indian capital markets. This entails a general background of the country and a more specific understanding of the industry in question. After assimilating all the facts and analyzing the relevant data pertaining to the identifiable asset classes to be included, we are able to propose sample portfolios, illustrating their value added over investments in a single asset class. Finally, strategies for distribution and implementation of multi asset funds are proposed, along with foreseen challenges.

3.1 Background Research

Firstly, a fact based approach is used to collect all relevant data to facilitate conclusions on the market for multi asset funds. Starting with a macro perspective of India’s economy and the key statistics that will be drivers of the economy over the next few years. Since the advent of liberalization in the early 1990s, regulation has driven investment trends and thus research into the regulatory policies was conducted to provide a brief overview of the regulation of capital markets in the country. The next step was to conduct a detailed analysis of the Asset Management Industry in India, extending to the developing Hedge Fund Industry. Since this is the target industry for proposed entry, research conducted was not only specific to historical and projected growth, but also essential factors such as profitability, market penetration and distribution. A list of prospective distribution and branding partners is provided to enable fact based decisions on possible partnerships that are essential to product diffusion in a market where reputation and branding are of prime importance. To understand the potential market and later segment it for targeted distribution and marketing, research was conducted into the different types of investors in India, their respective investment preferences and distribution of wealth. Growth projections from various sources were collected to understand the market potential over the next few years. Before moving to the next segment pertaining to data analysis, a brief overview of multi-asset investing is provided along with the existing products and the potential to design and introduce new products that will have an early mover advantage in a market that is projected to grow rapidly.
3.2 Data Acquisition, Analysis and Design

Data was collected for the five identified asset classes, namely Equity, Real Estate, Commodities, Hedge Funds and Treasuries. To capture their intrinsic risk and return characteristics, firstly indices representing each asset class were chosen as follows:

- Benchmark – Bombay Stock Exchange Sensitive Index
- Equity – National Stock Exchange S&P CNX Nifty Index
- Real Estate – Bombay Stock Exchange Realty Index
- Commodities – Multi Commodity Exchange Comdex
- Hedge Funds – Eurekahedge India All Strategies Hedge Fund Index
- Government Treasuries – 91-day T-bill Yield

Data on monthly returns was collected to calculate expected annualized returns and standard deviation, along with the Sharpe ratios of each asset. Calculating the Sharpe ratio is essential as many asset classes have returned exceptional returns over the past five years, however with equally high volatility. Cumulative returns were also calculated for the past five years. The BSE Realty Index and the MCX Comdex are relatively new indices and were established only in the past five years. Hence a comparison of all asset classes is performed for the period beginning January 2006 and ending March 2011. This time period is a good representation of the high growth experienced by all asset classes and also incorporates sharp downturns post January 2008, resulting from the global financial crisis and the recovery thereafter.

Once the key statistics of the data were calculated, the next step was to build portfolios with optimal asset allocation based on expected return and standard deviation. A model incorporating the Optimal Combination of Risky Assets (OCRA) was used to determine sample multi asset portfolios, also including the risk free asset of Government Treasuries. In determining the allocation, it is essential to understand the relationship between the asset classes represented by the correlations of returns over the past five years. The effect of this relationship is illustrated by comparing the difference in allocations once the correlations are taken into consideration. The optimal portfolio had better returns and volatility when compared with an equal-weighted portfolio. Finally, comparing the multi asset portfolio with firstly the benchmark, and then the
other asset classes shows the value added of multi asset portfolios. The asset allocations can be
dynamically altered with the changing expected return and volatility of each asset class.

Sources of primary data:

a. Thompson Reuters DataStream
b. Securities and Exchange Board of India
c. Reserve Bank of India
d. Government of India’s Ministry of Finance
e. Office of the Economic Advisor
f. Bombay Stock Exchange
g. World Bank World Development Indicators
h. Confederation of Indian Industry

Sources of secondary data:

a. McKinsey Global Institute
b. KPMG Research
c. IIMS DataWorks
d. Merrill Lynch Wealth Management
e. Eurekahedge

3.2 Market Segmentation and Competitive Strategy

The final section of this paper pertains to segmenting the target market and recommending
breakthrough strategies for implementation. These strategies are determined taking into
consideration the current state of the industry as well as projections for growth over the next few
years. Distribution is crucial and the emphasis is on proposed strategic alliances. An effort is
made to focus different distribution strategies for the respective market segments. A four actions
framework is used to propose changes that can be made to current industry norms in order to
gain a competitive positioning in the market.
4. Country analysis

4.1 Background

From the beginning of the 1990s, India has been at the center of robust economic development, with high GDP growth rates, influx of foreign investment and government policy changes targeted toward liberalization. India, in the late 1980s, had seen an economic crisis resulting from a current account deficit and overvaluation of its currency. Foreign exchange reserves had decreased and the effects of rising oil prices due to the Gulf war, together with declining export levels, manifested through a balance of payments crisis reaching a critical level by mid 1991. The country’s foreign exchange reserves had decreased by over 50% in June 1991, from the already depleted January level of $1.2 billion.1 Diminishing investor confidence and lack of credit availability exasperated the problem and time came for drastic measures to be taken. The newly formed Congress government led by Prime Minister P.V. Narasimha Rao appointed Dr. Manmohan Singh as the Finance Minister to establish economic reforms that collectively initiated India’s economic liberalization. The primary objective of these reforms was to make progressive shifts from socialism to capitalism: from a closed to a market economy.

The effects of colonialism started to make way for an open economy and gradually, India became one of the fastest growing economies in Asia. The proverbial “Hindu Growth Rate,” which stagnated between 3.2% and 3.5% in the pre-liberalization economy saw rapid increases as early as 1991 itself. While much of the world’s focus on India has come over the past five years with GDP growth rates nearing double digits, the country’s GDP growth from 1991 to 2006 was fourth highest of all emerging markets at 6.2%, only behind China, Vietnam and Malaysia at 10.2%, 7.6% and 6.3% respectively.2 Since 2006, India has seen an even higher growth rate at 8.91% making the country the 11th largest economy in the world in nominal terms at $1.25 trillion and 4th largest in PPP terms at $3.25 trillion.

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1 What Caused the 1991 Currency Crisis in India? Cerra and Saxena. 2002
2 World Bank WDI database
Economic growth, however, has not been evenly distributed across the country with states in the South and West being major beneficiaries of growth and 300 million of its 1.1 billion population still living below the poverty line. India’s population is largely agricultural with over 60% living in rural villages.

4.2 Economic Climate

Since 1992, India has gradually emerged as one of the favored investment destinations in the world, with an increasing investment surplus and high projected growth rates. High GDP growth, stronger regulation and heightened competition between financial service providers have been the hallmark of the Indian capital markets over the past five years. GDP growth, which was at 8.6% in 2010, is projected to grow at 5.8% till 2050. Per capital income is also projected to increase from the current level of $2,932 to $20,000 by 2050. The average GDP growth rate has been 6.35% over the past decade and 7.6% since 2007. Stock market capitalization has grown at 14.1%, only behind Brazil and Russia at 20% and 15% respectively. Foreign Institutional Investment inflows, which were at $244 million in 1992, increased to their highest level of $27.2

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3 *India: Democracy and Development*. Vietor and Forrest, 2009
billion in 2008, however dropping sharply in 2009. Foreign investment has also helped India increase its Forex reserves to over $303 billion (as at March 2011).\footnote{Reserve Bank of India}

Increasing investor participation and the influx of foreign investment has spurred the stock markets, especially since 2004, with market capitalization as a percentage of GDP increasing to a high of 108\% in 2008. The single stock futures market in India is the largest in the world today.

\textbf{Fig 4.2 Bombay Stock Exchange Market Capitalization (\% of GDP)}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{fig42.png}
\caption{Bombay Stock Exchange Market Capitalization (\% of GDP)}
\end{figure}

\textit{Source: SEBI}

The primary driver of GDP growth has been the services sector, registering a 9.4\% growth rate in 2009, significantly higher than the Manufacturing and Agricultural sectors, with 2.4\% and 1.6\% growth respectively. The Services sector is the major contributor to GDP, with the sector’s percentage share of GDP having increased from 53\% in 2006 to 57.8\% in 2011 (year-to-date). Even with the high proportion of agricultural population in the country, the share of Agriculture has been on the decline and is currently at 14.2\%.
Inflation continues to be a major concern in India. The widely used all-commodity Wholesale Price Index (WPI), has grown by over 45 points over the past four years (using 2006 as the base year). In the same period, Inflation, as measured by the Consumer Price Index, has almost doubled from 6.7% to 12.37% (highest in 13 years). This rate was almost three times as high as the Reserve Bank’s target rate of 4.1%. High inflation has spurred a demand for investment avenues that provide inflation beating returns.

Source: Office of the Economic Advisor to the Government of India, Ministry of Commerce
India has one of the highest savings rates in the world, mostly attributable to the private sector. Gross Domestic Savings in 2010 were at 33.7%, of which 31.6% came from the private sector. Total financial savings were at 11.8%, an increase from 10.1% in 2005. The high potential for fund managers in the Indian market is evidenced by the Saving-Investment gap, which has increased from -0.4% in 2005 to -2.8% in 2010. 

![Fig 4.5 Gross Domestic Savings (% of GDP)](image)

The effect of the subprime mortgage crisis on the Indian capital markets initially was positive as investors redeployed funds toward emerging markets from September 2007 to January 2008. This effect, however, was short-lived as GDP growth declined from the 9.6% high of 2008 to 5.1% in 2009. Portfolio inflows turned negative, amounting to -$13.1 billion from 2008 to 2009. Foreign Direct Investment (FDI) remained positive even in uncertain economic conditions and grew by $35 billion in the same period, signaling investors’ confidence in the Indian growth story.

Capital markets have seen improved liquidity since 2000, when short selling was first allowed by the Securities and Exchange Board of India, as well as the introduction of exchange traded derivatives in 2001. The move from fixed to rolling settlement cycles of T+2 days is cited as a significant reason for improved liquidity of the capital markets. By 2007, India had the third largest equity market in the world in terms of the number of trades executed per day.

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7 Central Statistical Organization, Government of India, Ministry of Statistics and Program Implementation
5. Regulation

5.1 Domestic Financial Markets Regulation


Before the establishment of SEBI, brokerage fees and commissions were included in the security prices when reported to customers. In an effort to improve transparency, SEBI now requires all fees to be disclosed separately and securities to be delivered in a dematerialized ("demat") form. Regulatory bodies for different financial activities operate under the purview of SEBI and have direct oversight of financial market functions. The regulatory bodies are listed below.

<table>
<thead>
<tr>
<th>Function</th>
<th>Acronym</th>
<th>Regulatory Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Markets</td>
<td>SEBI</td>
<td>Securities and Exchange Board of India</td>
</tr>
<tr>
<td>Asset Management</td>
<td>AMFI</td>
<td>Association of Mutual Funds in India</td>
</tr>
<tr>
<td>Insurance</td>
<td>IRDA</td>
<td>Insurance Regulatory &amp; Development Authority</td>
</tr>
<tr>
<td>Banking</td>
<td>RBI</td>
<td>Reserve Bank of India</td>
</tr>
<tr>
<td>Pension Funds</td>
<td>PFRDA</td>
<td>Pension Fund Regulatory &amp; Development Authority</td>
</tr>
<tr>
<td>Commodities</td>
<td>FMC</td>
<td>Forward Markets Commission</td>
</tr>
</tbody>
</table>

5.2 Overseas Investment Regulation

The Reserve Bank of India (RBI) regulates the flow of investments in and out of India. It sets policies for institutional and individual investors for investing overseas.

5.2.1 Institutional Investment Overseas

Indian Asset Management Companies can invest up to $300 million or 10% of their AUM (whichever is lower) overseas. RBI has been taking measured steps to allow more flexibility to institutional investors in their investment mandates. In 2008, it increased the aggregate
investment overseas by all AMCs to $7 billion.\textsuperscript{8} However, the current level of overseas investment is much lower than the maximum allowed, at $1.5 billion. Publicly listed Indian companies on the other hand are permitted to invest up to 50% of their net worth in direct overseas portfolio investments. For Joint Ventures, this limit is much higher at 400% of the company’s net worth.

5.2.2 Individual Investment Overseas

RBI has set very strict policies for individuals to invest overseas, in an effort to direct investable funds toward domestic markets. Currently, this limit for individual investors is $200,000 per person per year.\textsuperscript{9} While this limit may seem very low, it has increased significantly from the $25,000 per person limit in 2006. Moreover, the remittance is required to be made through an RBI authorized dealer. Investors are not allowed to remit funds for margin or margin calls under this policy. RBI also sets forth policy for income earned through investments made overseas, which is allowed to be reinvested. Dividend income from these investments is taxable in India. Short term capital gains (securities sold within 3 years) are taxed as regular income and long term capital gains are taxed at 20%.

5.3 Foreign Institutional Investor Regulation

FIIs in India are regulated by SEBI and the Reserve Bank. The Foreign Exchange Management Act (FEMA) sets the policies for the flow of foreign exchange in and out of the country. FEMA was incorporated in 2000 to replace the outdated Foreign Exchange Regulation Act (FERA) of 1973. FEMA allows FIIs to invest in Indian securities either directly, or through sub-accounts. Most FIIs invest through sub-accounts that are registered with SEBI. Each sub account is permitted to invest in up to 10% of a company’s paid up capital as long as the FII, including all its sub accounts, do not invest more than 24% of a company’s paid up capital. Unless an FII is registered as an all-debt holding, it is required to maintain a 70:30 debt to equity ratio.

FIIs that are not registered with SEBI, such as overseas hedge funds, use Participatory Notes (PNs) to invest in Indian securities. The primary purpose of PNs is to allow the investors of FIIs to participate in the Indian markets.

\textsuperscript{8} RBI lets mutual funds invest $7 billion abroad, Economic Times. April 2008
\textsuperscript{9} RBI Master Circular 2007
6. The Asset Management Industry

6.1 Competitive Environment

India's Asset Management industry has been at the center of liberalization policies and increasing competitiveness since the mid 1990s. Success of the industry can largely be attributed to deregulation and rapid advances in the stock markets. Life Insurance Corporation (LIC) was the only dominant player in the market till the late 1990s as entry of overseas asset managers was restricted. With liberalization, the competitive landscape has changed dramatically and the industry, as at 2010, has 41 major players.

![Fig 6.1 No. of Asset Management Companies in India](image)

The public sector’s stronghold over the industry has decreased, especially during the past five years evidenced by the decline in major public sector players from 11 to 5 since 2006 and 79% of the industry’s assets under management (AUM) being held by private firms as of 2009. Even with the growth of private sector companies, the India Asset Management Industry is well behind developed countries like the US, which boasts more than 700 fund houses, and also developing countries like China, with over 70 fund houses.\(^\text{10}\)

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\(^\text{10}\) Spencer Stewart research
The industry's competitive landscape has seen major shifts over the past decade as not only has the number of major players increased, but also has the number of product offerings. Almost 75% of the cumulative AUM is held by the ten largest players and 50% held by the five largest players. According to a study conducted by McKinsey, the Indian Asset Management industry is projected to grow at a 33% CAGR over the next five years, with the retail investor segment driving growth at an estimated 36%. While these projections may seem very high, the industry has seen an even higher growth rate of 47% from 2003 to 2008. Industry AUM is projected to increase from the 2010 level of $128 billion to $440 billion by 2015.\textsuperscript{11}

Table 6.1 Largest Asset Management Companies in India

<table>
<thead>
<tr>
<th>Name</th>
<th>AUM</th>
<th>Market Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Reliance Capital Asset Management Ltd.</td>
<td>$22.68b</td>
<td>16%</td>
</tr>
<tr>
<td>2 HDFC Asset Management Co. Ltd.</td>
<td>$19.53b</td>
<td>12%</td>
</tr>
<tr>
<td>3 ICICI Prudential asset Management Co. Ltd.</td>
<td>$14.63b</td>
<td>10%</td>
</tr>
<tr>
<td>4 UTI asset Management Company Ltd.</td>
<td>$14.53b</td>
<td>10%</td>
</tr>
<tr>
<td>5 Birla Sun Life Asset Management Co. Ltd.</td>
<td>$12.82b</td>
<td>10%</td>
</tr>
<tr>
<td>6 SBI Funds Management Pvt. Ltd.</td>
<td>$9.22b</td>
<td>5%</td>
</tr>
<tr>
<td>7 Franklin Templeton Asset Management Pvt. Ltd.</td>
<td>$8.77b</td>
<td>4%</td>
</tr>
<tr>
<td>8 DSP BlackRock Investment Managers Pvt. Ltd.</td>
<td>$6.15b</td>
<td>3%</td>
</tr>
<tr>
<td>9 Kotak Mahindra Asset Management Ltd.</td>
<td>$6.13b</td>
<td>3%</td>
</tr>
<tr>
<td>10 Tata Asset Management Ltd.</td>
<td>$4.63b</td>
<td>3%</td>
</tr>
</tbody>
</table>

\textsuperscript{11} India Offers Biggest Opportunity for Asset Management Companies. Economic Times, 2008
The total number of schemes offered collectively by all Indian AMCs is approximately 160 thousand, with a major bias toward Income and Equity funds, comprising 56% and 27% of total AUM respectively. The amount invested by Fund of Funds overseas is very low, at $560 million, comprising only 4.4% of AUM.

**Table 6.2 Fund Offerings by AMCs**

<table>
<thead>
<tr>
<th>Fund Type</th>
<th>Open End</th>
<th>Closed End</th>
<th>Interval Fund</th>
<th>Total</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>45.24</td>
<td>21.25</td>
<td>5.46</td>
<td>71.95</td>
<td>56.2%</td>
</tr>
<tr>
<td>Equity</td>
<td>34.18</td>
<td>1.16</td>
<td>0.00</td>
<td>35.34</td>
<td>27.6%</td>
</tr>
<tr>
<td>Balanced</td>
<td>3.66</td>
<td>0.23</td>
<td>0.00</td>
<td>3.89</td>
<td>3.0%</td>
</tr>
<tr>
<td>Money Market</td>
<td>3.89</td>
<td>0.00</td>
<td>0.00</td>
<td>3.89</td>
<td>3.0%</td>
</tr>
<tr>
<td>Gilt</td>
<td>0.77</td>
<td>0.00</td>
<td>0.00</td>
<td>0.77</td>
<td>0.6%</td>
</tr>
<tr>
<td>Equity Linked Savings</td>
<td>4.60</td>
<td>0.64</td>
<td>0.00</td>
<td>5.24</td>
<td>4.1%</td>
</tr>
<tr>
<td>Gold ETF</td>
<td>0.83</td>
<td>0.00</td>
<td>0.00</td>
<td>0.83</td>
<td>0.6%</td>
</tr>
<tr>
<td>Other ETF</td>
<td>0.50</td>
<td>0.00</td>
<td>0.00</td>
<td>0.50</td>
<td>0.4%</td>
</tr>
<tr>
<td>Investing overseas</td>
<td>5.60</td>
<td>23.28</td>
<td>5.46</td>
<td>5.60</td>
<td>4.4%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>99.29</strong></td>
<td><strong>23.28</strong></td>
<td><strong>5.46</strong></td>
<td><strong>128.02</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

Source: SEBI

Many major overseas asset managers are looking to gain access to the massive potential of growth in the Indian retail investor segment through acquisitions of existing AMCs with established distribution channels. Goldman Sachs Asset Management, which had received approval from SBI in 2008 to establish asset management services in India, announced on March 16, 2011 that they would acquire Benchmark AMC, which has $700 million in AUM. The industry has also seen similar acquisitions in recent times with Religare Enterprises, one of the country’s largest integrated financial services companies, acquiring Lotus India Mutual Fund in 2010 from Alexandra Fund Management and Sabre Capital,\(^2\) and Nomura acquiring a stake in LIC Mutual Fund. Projected industry growth is supported by increasing valuations of such transactions, with Goldman Sachs paying 4.1% of AUM for Benchmark, significantly higher than the 2.5% paid by Nomura.\(^3\)

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\(^2\) Goldman Sachs acquires Benchmark AMC – Press Trust of India, 2011

\(^3\) Goldman Sachs set to buy Benchmark Asset Management for 160 crores – Economic Times, 2011
6.2 Profitability

While industry statistics such as AUM, scheme offerings and number of firms has been rising, profitability has not been able to outpace growth. The growing competitive landscape has meant that increase in costs has outstripped profitability, measured as a percentage of AUM. In 2008, industry profitability was at 14 bps, a decrease from the 24 bps level of 2004. Regulatory pressure and heightened competition has caused AMCs to steadily lower management fees, even in the wake of increasing costs. Such a trend is changing industry dynamics where volume will be the key driver of top line growth. According to a recent BCG estimate, new entrants in India’s Asset Management industry will need $2.5 billion in AUM just to break even, illustrating the downward pressure on profitability.

Competition has also obligated Asset Managers to increase their marketing and distribution efforts. Homogeneity in product offerings has shifted the onus on building brand names, with its associated sales and marketing costs. As a result, expenses as a percentage of AUM have increased to 113 bps (in 2008) from the 41 bps level of 2003.

Fig 6.3 Asset Management Industry Profitability

![Profitability Chart]

Source: CII-KPMG

14 Confederation of Indian Industry
The industry saw a landmark regulation in January 2008, where the Securities and Exchange Board of India (SEBI) imposed a “no entry load” mandate on direct investment in mutual funds. The typical entry loads, averaging 2.25% across all fund houses, was a major source of revenue and profitability for AMCs industry wide. Contrary to intuition, however, cumulative earnings of all the 41 AMCs in India increase by almost 300% in 2010, notwithstanding the effects of the new regulation. Total earnings reached their highest level in 2010, at Rs. 935.6 crore (approx. $208 million) from the 2009 level of Rs. 243.5 crore (approx. $54 million). This rise in profitability has been attributed to fund houses making concerted efforts to decrease costs and focus on product offerings. According to Mr. A Balasubramaniam, CEO of Birla Sun Life Asset Management Co. Ltd., the country’s fifth largest AMC by AUM, “profitability improvement is on asset mix change, fixed income volume and the focus on cost.” On average, the industry saw a 6% decrease in costs in the same period.

AMCs have shifted focus from peripheral product offerings and turned to their core business of equity and fixed-income related products. However, it can also be argued that the increase in profitability was not related to a change in the regulatory environment, but rather due to a trend of recovery from the recent global financial crisis, which had severely affected the industry in 2008 and 2009. According to Mr. S. Sikka, CEO of Reliance Capital Asset Management, the country’s largest AMC, “the profitability is nothing to do with new SEBI guidelines. In 2008-2009, PAT [Profit after taxes] was low due to slowdown. So the base was low and that reflected increase in profitability.”

The increase in profitability, however, may be misleading as 85% of the $208 million aggregate number is attributed to the top ten players listed above. Smaller AMCs have faced the brunt of the regulatory change and are banking on AUM growth over the next 3-5 years to generate higher levels of income. Average industry operating margins declined from 33% in 2007 to 22% in 2010.

15 Fund houses' profit climbs 3 times in entry load-free year. Economic Times, 2011
16 MFs' profits surge 300% in 2009-10. The Times of India. 2011
6.3 Market Penetration

While industry AUM has increased at very high rates and growth is projected to continue, penetration has been an issue faced by Asset Management Companies, with over 75% AUM attributed to only eight major cities. One of the primary reasons for this trend is the high cost associated with targeting low income sectors where population density is low and ticket sizes are small. In the face of heightening competition, asset management firms are looking to expand to newer and relatively untapped markets in the retail investor segment.

AUM as a percentage of Market Cap peaked in 2000 at 14.4% and decreased to a low of 7.6% in 2007. This metric can be attributed to the high growth rate of the stock markets, suggesting that AUM has kept pace with GDP growth. Another indicator, AUM as a percentage of GDP, increased steadily from 5.3% in 2000, reaching its highest level in 2009 at 18.2%, suggesting that investors turn to mutual funds as a safer investment in times of stock market volatility, as was the case in 2009. However, these penetration levels are much lower when compared to the US, at 79% and Brazil at 39%.

Fig 6.4 AMC Market Penetration

Source: Morningstar India

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18 Indian Asset Management: Achieving broad based growth, McKinsey India Financial Institutions Practice, 2008
Although the top eight cities account for 15% of penetration, the overall penetration of households is very low at 3-4%. Institutional penetration, while on the increase, is also very low with 50% AUM attributed to large corporations. The Small and Medium-sized Enterprises (SME) sector is projected to drive growth of this segment and is being targeted by many fund managers for new business.

Industry AUM grew from $94 billion to approximately $140 billion year-on-year from 2009 to 2010. A further segmentation of the data shows that while AUM attributed to HNIs was higher in 2009, the Retail investor segment grew the most, by over 83%. The only sector that showed a decrease in AUM was Banks, with a 6% YoY decrease. The largest sector is Corporations, which saw the AUM attributable to it increase from $47 billion to $70 billion.

Fig 6.5 Segmented AUM of Asset Management Companies (in USD billion)

Source: AMFI
6.4 Distribution

Although a large proportion of AMC business in India comes from the large cities, Asset Managers are seeking to capitalize on rising income levels and investor awareness in smaller towns and are hence relying on leveraging all available distribution channels. AUM attributed to the top 10 cities has decreased from 92% in 2005 to 80% in 2009, albeit still very high.19 According to Anthony Heredia, CEO of Morgan Stanley Investment Management in India, “To see significant growth in rural markets we need improvements in banking services, more organized distribution, and the right infrastructure to enable cost efficient customer service. Once that happens, a larger number of asset managers will increase their focus on this area as a means to drive long term asset growth.” Asset managers are seeing a tremendous potential of growth from the 18 to 59 age group, which currently comprises of 340 million individual investors. The four major distribution channels used by AMCs are Banks, Distributors, Independent Financial Advisors and Direct Sales. Although there are over 92 thousand registered mutual fund distributors in the country, they lag far behind the number of insurance agents, with the former comprising only 3.7% of the 2.5 million insurance agent base, and facing even higher competition in the wake of the SEBI regulation doing away with the typical 2.25% entry loads of mutual funds.

Fig 6.6 AMC Distribution Channels

![Diagram of AMC Distribution Channels](source: AMFI)

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19 Association of Mutual Funds in India
6.4.1 Banks

Together with registered distributors, banks form the largest channels for distribution of AMC products in India. Even though Independent Financial Advisors outnumber banks in terms of personnel dedicated to selling mutual funds, banks have a much larger share of AUM, at approximately 65%. Banks carry out these functions through wealth management services to high net worth individuals (HNIs) as well as through financial services to retail investors. While major private sector banks such as Citi, HSBC, Kotak and ICIC have become the largest mutual fund distributors in India, public sector banks such as State Bank of India are looking to increase their focus on mutual fund distribution by establishing retail units in Tier 2 and Tier 3 cities, a market that has traditionally been overlooked by AMCs for distribution.

Due to the relatively new regulation restricting entry loads, many IFAs have turned away from selling mutual fund projects, which has made AMCs look to banks to take over the their distribution share. According to Srinivas Jain, Chief Marketing Officer of SBI Mutual Fund, "Partnering with banks is the only way to widen the reach of mutual funds in India...the key to success will be giving training to bank officials."\(^\text{20}\) The 20 Tier 2 cities currently contribute only 17% to industry AUM, which shows the tremendous potential for concerted distribution efforts to penetrate this market with a trend of growing investable surplus.

6.4.2 Independent Financial Advisors (IFAs)

IFAs lead AMC distributors in the retail investor segment and account for approximately 65 thousand registered distributors. While HNIs have traditionally favored banks for their mutual fund transactions, IFAs are looking to capture market share in this high growth sector due to high ticket sizes. AMCs are looking to engage this segment of the distribution mix by building their own IFA verticals due to their growing popularity with HNIs, as they provide flexibility to investors according to their preferences.

6.4.3 Direct Sales

This final part of the distribution mix forms the smallest network in terms of AUM. Traditionally, AMCs have used direct sales very selectively, primarily in transactions with very

\(^{20}\) With distributors cold, AMCs turn to banks to sell units. Economic Times. 2010
large ticket sizes. However, increased industry competition and the consequent downward pressure on margins have induced some AMCs to focus more on direct sales. State Bank of India, the country's largest bank, has set up over 100 points of direct acceptance across the country, with 28 investor service centers, 45 investor service desks and over 20,000 agents. Other AMCs such as Reliance Capital and HDFC are believed to be following suit.21

6.5 Hedge Funds in India

The Indian Hedge Fund industry is still at a developing stage, with only 60-70 fund offerings and average AUM of $70 million per fund. Regulatory pressures have historically kept fund managers from venturing in the Indian Hedge Fund landscape. However, over the past five years, the sector has gained prominence due to the rapidly growing HNI population, dynamically changing needs of institutional investors, and investors' desire to gain superior, yet risk-adjusted, returns. The industry saw its most productive period from 2005 to 2007, when AUM increased by over 150% and number of funds increased from 20 to over 60.22 The Eurekahedge India Hedge Fund Index, for all strategies, grew by over 100% in the same period. The Index has had an annualized return of 7.65% since inception in 1999, with an annual standard deviation of 23.7% and a Sharpe Ratio of 0.24.

Fig 6.7 Eurekahedge India Hedge Fund Index (All Strategies)

Source: Eurekahedge

21 Evolving Distribution Strategies; reaching out to retail investors, FPSB, Syed Shahbubdin
22 Eurekahedge
Indian hedge funds faced a turbulent period in 2008, where AUM decreased significantly due to losses and a flight to safety by investors. Indian hedge funds had to bear the brunt of the recent financial crisis, with a sharp AUM decline of 70% in 2008 and the Hedge Fund Index registering net returns of negative 50%. Traditionally, Indian hedge funds garnered high returns by investing in Indian mid-caps that saw a bull-run until 2008. These mid-caps were the worst performers when the equity markets dropped sharply in 2008, hence causing hedge fund returns to consequently drop as well. However, there was a steep reversal in 2009, with average returns of 53.6%. 2010 saw a reversal in this trend and Indian hedge funds posted the best returns globally, at 4.6%. The Indian equity markets grew only 2% in the same period. Moreover, 2011 has already seen tremendous inflows into the Indian hedge fund space, with industry growth estimated at 30% by Eurekahedge. A major reason for this surge has been the buoyant stock market, as a majority of funds are equity focused. In fact, 68% of Indian hedge funds employ long-short strategies with an overwhelming 70% equity focus.\(^{23}\) The total industry AUM is currently estimated at $5 billion.\(^{24}\)

The industry is currently at a transitional phase, with many fund managers shifting their mandate from a primarily equity focus to multi strategy funds, which have increased their market share from 10 to 20%, while equity only funds have seen a decline in market share by over 15%. Asset classes such as Commodities, Fixed-income and Gold are gaining prominence in the portfolios of many fund managers as a more risk-centric approach has become the need of the hour. Hedge funds in India primarily employ strategies, namely Long/Short Equity and Multi Strategy. The Long/Short Equity index comprises 22 constituents while the Multi-strategy index comprises 6 constituents.

\(^{23}\) *India focused hedge funds ranked among world’s best performers*, Economic Times, 2010
\(^{24}\) *The flip-flop story of Indian hedge funds*, International Business Times, 2010
Multi-strategy funds have historically performed better than Long/short Equity funds with a 9.37% annualized return compared to 7.36% for the latter. However, they have also returned a higher standard deviation of 26.26% when compared to 22.49% for Long/Short Equity. A comparison of the Sharpe Ratios shows that Multi-Strategy funds have shown higher risk-adjusted returns, with a higher Sharpe Ratio of 0.28. 2010 was a year of positive returns, with multi-strategy funds showing the best performance with annualized return of 15.35%. 2011, on the other hand, has not begun as well for Indian hedge funds as all strategies have thus far shown negative returns, with Multi-strategy once again outperforming Long/short Equity.

Table 6.3 Performance Metrics of Indian Hedge Funds

<table>
<thead>
<tr>
<th>Key Statistics</th>
<th>Long/Short Equity</th>
<th>Multi-strategy</th>
<th>All Strategies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annualized Return (%)</td>
<td>7.36</td>
<td>9.37</td>
<td>7.65</td>
</tr>
<tr>
<td>Best Monthly Return (%)</td>
<td>25.34</td>
<td>16.8</td>
<td>25.35</td>
</tr>
<tr>
<td>Worst Monthly Return (%)</td>
<td>-18.09</td>
<td>-31.76</td>
<td>-19.18</td>
</tr>
<tr>
<td>2010 Return (%)</td>
<td>10.71</td>
<td>15.35</td>
<td>13.1</td>
</tr>
<tr>
<td>2011 Return (%)</td>
<td>-10.27</td>
<td>-6.58</td>
<td>-9.84</td>
</tr>
<tr>
<td>Rise in NAV Since Inception Date</td>
<td>121.03</td>
<td>171.77</td>
<td>127.84</td>
</tr>
<tr>
<td>Last 3 Months (%)</td>
<td>-8.2</td>
<td>-4.75</td>
<td>-7.18</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.24</td>
<td>0.28</td>
<td>0.24</td>
</tr>
<tr>
<td>Annualized Std Deviation (%)</td>
<td>22.49</td>
<td>26.26</td>
<td>23.7</td>
</tr>
<tr>
<td>Percentage of Positive Months (%)</td>
<td>58.21</td>
<td>61.19</td>
<td>58.21</td>
</tr>
</tbody>
</table>

Source: Eurekahedge
7. Major Asset Classes in India

To analyze the trends in investment strategies in India, as well as the changing demands of investors over time, we take a look at the major asset classes that are available to Indian investors. The profiles of these asset classes not only gives a better understanding of the capital markets and savings trends, but also enables fund managers to determine the asset classes that may be included in multi-asset products. Following are the major asset classes available in India.

7.1 Direct Equity

The recent boom in the Indian stock markets has prompted many investors, who traditionally preferred to stay away from the stock markets, to direct an increasing proportion of their investable funds toward direct equity investments. As at March 2010, the cumulative total invested in Direct Equities was approximately $1.3 trillion. However, retail investors only contributed 9.7% of this amount, with domestic and foreign institutional investors contributing over 62%. Total individual wealth contribution to Direct Equity investments was 31% of the cumulative individual wealth in the country.

Fig 7.1 Breakdown of Direct Equity Investments

![Image of pie chart showing the breakdown of Direct Equity Investments: 9.7% Promoter Holdings, 28.1% Retail, 62.2% Institutional. Source: SEBI]
Most of the Direct Equity investment is done through the 23 stock exchanges in India. The Bombay Stock Exchange (BSE) and National Stock Exchange (NSE) are most actively traded. The three largest sectors of investment are IT, Financial and Energy. Currently, the BSE has over four thousand listings, which is more than any stock exchange in the US. The market cap of BSE saw tremendous growth from 2001 to 2008, increasing from approximately $100 billion to $1.5 trillion, with a sharp decline in 2009 due to adverse market conditions.

Fig 7.2 Market Cap of BSE and NSE (in USD billion)

Source: SEBI

7.2 Insurance

Life insurance products have the highest penetration among all investment options in India. The major reason for this is the low risk profile, together with tax benefits provided to Life Insurance investors. Life Insurance is categorized in to the Public and Private sectors. Life Insurance Corporation (LIC) is the only public insurer and the largest asset manager in the country, accounting for 71% of the $220 billion insurance industry AUM. There are 21 major private sector players that account for the other 29% AUM. The industry was dominated by LIC up until 2000 and the private players have only emerged in the past 10 years. Approximately $40 billion of premiums are invested in the equity markets through Unit Linked Insurance Plans (ULIPs).

Nielsen Life Survey 2008
India’s insurance industry is projected to grow at 15-20% per year over the next five years. LIC itself saw a 32% rise in AUM in 2009.

Fig 7.3 Breakdown of Insurance Assets

Source: IRDA

The large proportion of investments by life insurers are in central government securities, at 43%. Other major investment avenues are state government securities and infrastructure investments.

Fig 7.4 Life Insurance Investments

Source: IRDA

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26 McKinsey Research
27 Life Insurance Corporation of India says assets rise 32 percent to $250 billion, Bloomberg, 2010
7.3 Fixed Deposits

This investment avenue, due to its safety feature, has always comprised of a large proportion of investor savings. They are extremely popular with the Retail investor segment as they carry an insurance from the Deposit Insurance and Credit Guarantee Corporation for up to Rs. 100, 000 (approximately $2,100). Deposits are made at fixed interest rates and maturities, which may last from fifteen days to ten years. Investors have the option to choose between Bank Fixed Deposits and Corporate Fixed Deposits. 50% of all household savings in India are in Fixed Deposits and over 80% of all urban households invest in them. They form a major source of competition for other asset classes as the prevailing high interest rates make them even more attractive for investors looking for capital preservation.

Fig 7.5 Bank Deposit Interest Rates

While interest rates vary from one bank to the other and from one corporation to the other, the average interest rate for a five year deposit currently is 8% per year. Interest is treated as ordinary income for the purpose of taxation. Fixed deposits are overwhelmingly dominated by bank deposits, with cumulative funds of approximately $850 billion as of 2010, as compared to $13 billion in corporate fixed deposits.
7.4 Provident Fund

Provident funds are used for the dual purpose of tax savings and capital preservation. The two types of Provident Funds available are Public Provident Fund (PPF) and Employee Provident Fund (EPF). PPFs are voluntary investments with the central government and pay a fixed 8% interest rate with a 15 year maturity. On the other hand, EPFs form a retirement planning tool available to workers in which employers contribute a certain percentage to the investment pool. Since PPFs are voluntary, their total contribution is much lower, at 25% of the total $47 billion AUM. The biggest contributors to PPF investments are the middle-income segment (with annual income between $1,100 and $4,200), accounting for over half of the total AUM. The higher income groups have traditionally invested a very small percentage of their investable surplus in PPFs.

Fig 7.6 Public Provident Fund Investments by Income Group

![Fig 7.6 Public Provident Fund Investments by Income Group](image)

Source: SEBI

7.5 Mutual Funds

Mutual Funds have seen high growth rates and increasing penetration over the past five years. Much of this growth is attributed to increasing income levels and growth of the stock markets. Industry AUM had increased at a 29% CAGR from 2004 to 2008, increasing to $114 billion in 2007 before a decline in 2008. Current AUM is approximately $154 billion. HNIs and retail investors hold approximately 45% of AUM, with institutional investors and corporate accounting.

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for the other 55%. Mutual funds have traditionally invested in three major asset classes, namely Equity, Debt and Gold, typically with a focus on a single asset class. Some Asset Management Companies are looking to gain exposure to other asset classes such as ETFs, Commodities and Real Estate with New Fund Offerings (NFOs) in the pipeline.

**Fig 7.6 Mutual Fund Investments**

![Circle chart showing mutual fund investments by asset class]

*Source: AMFI*

The share of household savings in mutual fund AUM has been increasing, from the 1.2% level in 2005 to 7.7% in 2009, as retail investors and HNIs seek to gain exposure to the capital markets through new fund offerings. Although AUM and contributions have increased at high rates, India’s share in the global mutual fund industry is at a mere 0.32%, illustrating the potential for further growth.

**Fig 7.7 Mutual Funds Percentage Share in Household Savings**

![Bar chart showing mutual funds percentage share in household savings]

*Source: CII-KPMG*

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29 Confederation of Indian Industry  
30 Association of Mutual Funds in India and KPMG research
7.6 Real Estate

The real estate sector in India saw a tremendous boom from 2005 to 2008, with rapidly increasing valuations due to high demand. Stock prices of major real estate companies soared during that period, evidenced by the market cap of DLF, the country's largest real estate company, reaching $22 billion in 2008. However, there was a sharp decline in prices in 2008 and associated share prices declined consequently. The BSE Realty Index had peaked to a 14,000 level in early 2008 and dropped to less than 2000 within a year. The expected demand for Real Estate in India is currently above 150 million square feet.

![Fig 7.8 BSE Realty Index](image)

Real Estate Mutual Funds (REMFs) in the residential and commercial sectors were allowed to be set up by SEBI in 2008 through Real Estate Operating Companies to give retail investors access to the property market. Within two years, total AUM of REMFs grew to over $1.5 billion, of which approximately $1.2 billion is held by institutional investors.

7.7 Private Equity

This sector is projected to grow at a very rapid rate, primarily due to the growth of the Small and Medium-sized Enterprises (SMEs) sector in India. Deal flow had peaked in 2007 to approximately $15 billion. However, like most other asset classes, there was a sharp decline thereafter. AUM is nonetheless expected to grow back to the highs of 2007 by 2011. Similarly,
PE investment in SMEs had crossed the $2 billion mark and declined to approximately $700 million in 2009. Deal flow is expected to rise to over $15 billion by 2012 with an expected growth rate nearing 50% per year.\textsuperscript{31}

**Fig 7.9 Private Equity Investment in Indian SMEs**

![Graph showing deal flow and number of deals](source: IndiaPE.com)

The average deal size in Indian Private Equity is between $50 and $200 million. The total industry AUM as at 2010 was approximately $43 billion with over 200 PE firms in operation across the country. Approximately 20% of industry AUM is attributed to HNIs with institutions holding a major share.

### 7.8 Commodities:

The market for commodities in India has been growing at a steady rate as the asset class has become increasingly popular among Indian investors. The three primary commodity exchanges in India are the Multi-commodity Exchange (MCX), the National Multi Commodity Exchange (NMCE) and the National Commodity and Derivatives Exchange. The annual turnover of India’s commodities markets in 2010 was approximately $35 billion, with increasing participation in commodities other than Gold, which has traditionally been a popular investment vehicle in India. Commodities offer tremendous potential to become one of the more popular asset classes for market-savvy investors. Commodities-related activities contribute over 58% to the country’s GDP, illustrating their significance.

\textsuperscript{31} Indian Private Equity investments may touch 2007 peak this year, Economic Times, July 2010
8. Target Market

The market for multi-asset funds in India can be segmented on the basis of:

- Investor classification
- Income level
- Geographic location

8.1 Investor Classification

8.1.1 Individual Investors

This segment is categorized into Retail Investors and High Net worth Individuals (HNIs). The total wealth held in financial assets (not including real estate and gold) by individuals in India as of 2010 is approximately $1.6 trillion, of which over 60% is attributed to direct equity and fixed deposits (including bonds).\textsuperscript{32} Individual wealth is projected to grow by a 25% CAGR over the next 3 years, reaching a cumulative total over $3.2 trillion by 2013.\textsuperscript{33} At the same time, individual wealth held globally is expected to grow at a much lower rate of approximately 5.6%. This segment is hence highly attractive to fund managers looking to either enter or expand their business in India.

Fig 8.1 Distribution of Individual Wealth in India

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{distribution.png}
\caption{Fig 8.1 Distribution of Individual Wealth in India}
\end{figure}

Source: SEBI

\textsuperscript{32} Handbook of Statistics on the Indian Securities Market 2009, SEBI
\textsuperscript{33} McKinsey Research
8.1.1.1 Retail Investors

Retail investors are individuals who purchase and sell relatively small amounts of securities for themselves, and not for any institution or organization. In India, SEBI categorizes Retail investors as those who finance a listed company in the equity or debt markets up to a limit of Rs. 1,00,000 (approx. $2,100) through an IPO. While this definition applies to IPOs, investment managers in India take this as a baseline for defining retail investors. However, due to the growth of the capital markets, SEBI is seeking to increase this definition to include investments of up to Rs. 2,00,000 (approx. $4,200). This does not mean that investors purchasing larger amounts are not included in this category. The term usually refers to investors making smaller transactions than those categorized under the HNI segment. Generally, the retail investor segment includes individual investors in the low to middle income groups.

Retail investors in India have a low risk profile with a conservative approach to their investments. India's household savings rate, at 22% of GDP, is amongst the highest globally. As at 2010, cumulative household savings in India amounted to $376 billion, and projected to grow to $540 billion by 2013. Average household incomes are expected to grow by over 300% by 2025, which will make India the fifth largest consumer economy in the world. However, at present, only a mere 7% of all Indian households invest in the capital markets. High interest rates have also been a key driver of directing household savings toward fixed bank deposits. An analysis of retail investment preferences illustrates the conservative approach with a heavy preference for low-risk bank deposits, while equities comprise the lowest proportion due to their risky nature.

![Fig 9.2 Composition of Household Savings](source: SEBI; Deutsche Bank Research)
Apart from the low risk investment demands, major factors that have kept this segment away from the equity markets are low investor confidence and literacy. Regulatory bodies such as SEBI and AMFI have been taking steps toward increasing investor literacy, which has been identified as one of the major obstacles in the growth of capital markets. Due to this, AMCs have focused their efforts more on distribution and sales, rather than product innovation, limiting their reach to the highest earning cities. Consequently, the top 20 cities have contributed 90% to industry AUM and penetration levels are low even with increasing AUM.

The Indian middle class is defined by the National Council of Applied Economic Research (NCAER) as households with annual income between Rs. 200,000 (approx. $4,200) and Rs. 1,000,000 (approx. $21,500). This segment has caught the fancy of asset managers not just in India, but also overseas due to its high growth forecast and currently low participation. The Indian middle class is projected to grow from 50 million individuals in 2005 (comprising approximately 5% of the population) to 583 million individuals in 2025 (comprising 41% of the population). Even at the current level, retail investors account for over 85% of the daily trading volume on the National Stock Exchange.

The retail investor segment, with its high projected growth rate and rising per capita GDP, has thus become exceedingly attractive to asset managers. While historically, AMCs have not focused enough on innovations in product design, changing client mandates and competition from skilled overseas fund managers is driving the entire Asset Management industry to develop strategies to capture share in this segment. Moreover, the betterment of investor literacy has also gained prominence in the strategies of asset managers as it translates directly to increased participation in the capital markets, a large proportion of which could come through investments in AMC product offerings.

8.1.1.2 High Net worth Individuals (HNIs)

While there is no official definition of HNIs in India, the segment is generally categorized into individuals with liquid financial assets over $1 million. There is also a subcategory of Ultra High Net worth Individuals (UHNIs) with financial assets in excess of $30 million. HNI population growth rate in India has been at approximately 15% year-on-year since 2005 (only second to

34 McKinsey Global Institute
Singapore globally), as compared to the average rate of 12% in Asia-Pacific and 9.5% worldwide. The high growth rate can be attributed to improving employment opportunities as well as an increasing graduation rate of the middle income group to the high income group. Additionally, India has the youngest population of HNIs in Asia, accounting for 4.2% of HNIs in Asia-Pacific and 1.2% of HNIs worldwide. Along with Hong Kong, India had faced the largest decline in its HNI population during the recent financial crisis. However, the post-crisis resurgence has been exceptionally strong with a 50.9% growth in HNI population in 2010. HNI wealth also grew at a similar rate of 53.8% to $477 billion in 2010, the third largest in Asia, only behind Japan and China. As at 2010, there were 127 thousand HNIs and 1,000 UHNIs in India.

Fig 8.3 Indian HNI Growth (in thousands)

<table>
<thead>
<tr>
<th>Year</th>
<th>HNI Growth (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>70</td>
</tr>
<tr>
<td>2006</td>
<td>83</td>
</tr>
<tr>
<td>2007</td>
<td>100</td>
</tr>
<tr>
<td>2008</td>
<td>123</td>
</tr>
<tr>
<td>2009</td>
<td>84</td>
</tr>
<tr>
<td>2010</td>
<td>127</td>
</tr>
</tbody>
</table>

Source: Merrill Lynch & Cap Gemini

The largest HNI population is in New Delhi, Mumbai and Bangalore with 7% HNIs in the age group of less than 30 years. On average, the segment holds $3.5 million in assets. India’s HNI population is expected to grow at a 33% CAGR to 9.5 million individuals by 2025 and is expected to contribute 22% of the country’s disposable income. Total HNI wealth is projected to grow to $949 billion by 2015.

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35 *Indian HNIs prefer investment in India than abroad*, The Economic Times, June 2009
36 *HNI Wealth in India back to pre-crisis level*, Times of India, September 2010
37 Union Bank of India
38 Markets & Markets Wealth Management Report 2010

48
Expected growth levels of not only the HNI population in numbers, but also their contribution to income levels make the segment highly attractive to asset managers. AMCs have looked to capture market share in the retail investor space with more plain vanilla offerings. However, in the HNI space, there is much scope for product innovation with dynamically changing client mandates. Individuals with a large investable surplus are more akin to investments that have a higher expected return, albeit with a higher risk as well. Structured products, with the intrinsic characteristics of income and growth, are becoming more popular with this segment. High volatility of the equity markets, however, has been responsible for large fluctuations in HNI wealth, as evidenced by the huge decline in 2008 and the equally large resurgence thereafter. Investors are looking to diversify into other asset classes to control risk as well as gain exposure to the high returns being generated in assets such as Real Estate and Commodities. According to a survey of wealth managers conducted by DataMonitor, HNI wealth allocation in alternatives over the next two years is expected to rise to 12% from the current 8% level, and increasing further thereafter. At present, Equities make up the largest share of HNI wealth allocation at 32%, followed by 25% in Fixed Income, 22% in Real Estate, 13% in Bank Deposits and 8% in Alternatives.³⁹

³⁹ Merrill Lynch-Cap Gemini research
In devising strategies to target this high potential market segment, it is important to note their preferences for distribution channels. On average, 20% of Indian HNIs seek the advice of financial advisors in their investment decisions, with advisory asset management and tax planning being the most sought service, followed by financial planning services. Due to strict Reserve Bank of India regulations, limiting overseas investment to $200,000 per person per year, 82% of HNI investments are held within the country.

8.1.2 Institutional Investors

SEBI classifies Institutional Investors in India into the following:

- Pension Funds
- Mutual Funds
- Investment Trusts
- Insurance companies
- Endowment Funds
- University Funds
- Foundations or Charitable Trusts
- Asset Management Companies
• Nominee Companies  
• Institutional Portfolio Managers  
• Trustees  
• Power of Attorney Holders  
• Banks

Large corporations have accounted for 50% of the institutional investor business in India. Their significance in the country’s Asset Management industry is evidenced by their 63% contribution to total industry AUM, while representing only 3% of the industry’s total clientele.\textsuperscript{40} The Institutional segment also accounts for 62% of the market capitalization of the Indian stock markets, amounting to approximately $830 billion.\textsuperscript{41} Regulatory changes allowing privatization of the Asset Management industry since 2000 and foreign institutional investors to direct funds towards the Indian capital markets since 1992 have been key drivers of institutional investment. The sector has been targeted by asset managers to increase AUM as it has proved easier and cheaper to penetrate this segment than the highly spread out and low ticket size retail investor segment. Institutional investment in India is projected to grow at 25-33% over the next 5 years, with demand for products bolstered by the burgeoning SME sector.\textsuperscript{42} Institutional investors can be further categorized into Foreign Institutional Investors (FIIs) and Domestic Institutional Investors (DIIs).

8.1.2.1 Foreign Institutional Investors (FIIs)

FII investments have been a key driver in the development of the Indian capital markets. One of the features of the liberalization policy set forth in 1992 was to allow FIIs to invest in all securities traded in the primary and secondary markets. Since then, foreign institutional investment has increased at a rapid rate as FIIs have been attracted to the country’s high GDP growth, corporate earnings and per capita income. At present, there are 1,738 FIIs registered with SEBI, collectively accounting for $210 billion in total investment.

\textsuperscript{40} Indian Mutual Fund Industry – The future in a Dynamic Environment. CII-KPMG, June 2009  
\textsuperscript{41} Handbook of Statistics on the Indian Securities Markets 2010. SEBI  
\textsuperscript{42} Indian Asset Management: Achieving Broad-based growth, McKinsey Research, 2008
Regulatory policies of the Central Government and Reserve Bank have shaped FII investment trends over the past five years. Currently, under RBI regulation, FIIs are permitted to invest a maximum of $2 billion in government securities and $1.5 billion in corporate bonds. They are, however, not allowed to own more than 24% of the paid up capital of a publicly listed company.

One of the major reasons cited for the sharp drop in the Indian stock markets in 2008 was the decline in purchases made by FIIs. Even as the number of FIIs registered increased by 26, purchases made by FIIs saw a 75% decrease. The Bombay Stock Exchange Sensitive Index (BSE Sensex) dropped sharply from the January 2008 highs of above 20,000 to under 9,000 by March 2009, illustrating the effect of FIIs on the stock markets. However, FII purchases increased in 2010 and are expected to surpass the 2007 highs by 2012.
India now leads all Asian countries in attracting foreign institutional investment, 57% higher than second placed South Korea. The US has been the highest contributor to FII investment in India, with other major contributors being the UK and Western Europe. In Asia, Hong Kong and Singapore lead investments in Indian securities.
8.1.2.2 Domestic Institutional Investors (DIIs)

This segment is dominated by the public sector, with the government owned Life Insurance Corporation (LIC) being the country's largest institutional investor. Since a large proportion of the DII segment consists of government companies, they are subject to stringent regulation pertaining to their investment policies. Public Sector Undertakings (PSUs), which are companies in which the government owns at least a 51% stake, have been large contributors to the AUM of the Asset Management Industry. SEBI permits PSUs with an investable surplus over $70 billion to invest only 30% of their funds in equity focused mutual funds that are managed by the public sector, and requires all pension funds to invest 25-50% of their funds in government securities. The imposition of these regulations has created a limitation toward optimal asset allocation with altering market conditions, as these securities have long redemption periods and funds are held for long durations.

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43 SEBI India Finance and Investment Guide
8.2 Segmentation by income group

After having defined the types of investors, we can segment the market according to income. The population is divided into the following six income groups.

**Fig 8.9 Distribution of Population by Income Group**

![Distribution of Population by Income Group](image)

Source: SEBI

A large majority of the population is in the lowest group earning less than $1,100, comprising of over 800 million people, and only approximately 3.6 million people earn over $21,500. The two segments comprising of 4.2% of the population, earning between $4,200 and $21,700 are categorized as the middle class. This segment is expected to grow to over 40% of the population by 2025, hence making it a focus for financial service providers. After breaking down the population by income, it is useful to analyze the investment preferences of each segment into the asset classes listed in Section 7.

**Table 8.1 Investment Preferences of Income Groups**

<table>
<thead>
<tr>
<th>Income Group</th>
<th>Bank Dep</th>
<th>Insurance</th>
<th>MFs</th>
<th>Equity</th>
<th>SHG 44</th>
<th>NBFCs 45</th>
<th>Postal</th>
<th>Gold</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;$10,800</td>
<td>70.5%</td>
<td>5.3%</td>
<td>7.9%</td>
<td>6.5%</td>
<td>0.0%</td>
<td>0.2%</td>
<td>5.6%</td>
<td>4.0%</td>
</tr>
<tr>
<td>$4,200 - $10,800</td>
<td>73.2%</td>
<td>7.3%</td>
<td>6.2%</td>
<td>3.4%</td>
<td>0.1%</td>
<td>0.4%</td>
<td>5.1%</td>
<td>4.2%</td>
</tr>
<tr>
<td>$2,100 - $4,200</td>
<td>73.3%</td>
<td>9.8%</td>
<td>1.4%</td>
<td>0.7%</td>
<td>0.2%</td>
<td>1.4%</td>
<td>8.2%</td>
<td>5.0%</td>
</tr>
<tr>
<td>$1,100 - $2,100</td>
<td>72.1%</td>
<td>12.6%</td>
<td>0.4%</td>
<td>0.2%</td>
<td>0.5%</td>
<td>1.6%</td>
<td>8.7%</td>
<td>3.8%</td>
</tr>
<tr>
<td>&lt;$1,100</td>
<td>65.1%</td>
<td>15.4%</td>
<td>0.0%</td>
<td>0.1%</td>
<td>1.9%</td>
<td>2.5%</td>
<td>11.0%</td>
<td>4.0%</td>
</tr>
</tbody>
</table>

Source: SEBI

44SHGs (Self Help Groups) are financial intermediaries based in the rural sector providing microcredit
45NBFCs (Non-banking Financial Companies) provide banking services, but do not hold a banking license
The above table shows that investor preferences are overwhelmingly biased toward bank deposits due to the level of safety afforded by them. On the other hand, Mutual Funds have very low participation by all the income groups, especially the lower income segments, illustrating tremendous potential to increase market penetration.

8.3 Segmentation by geographic location

With such a vastly spread population, it is also useful to segment the market according to geographic location. The significance of geographic segmentation is illustrated by the large proportion of industry AUM attributed to the major cities, with the top 10 cities contributing 75% of AUM and the top 5 cities contributing 50% to AUM.

India’s population is firstly categorized into Rural and Urban. The Urban segment comprises of approximately 320 million people with an average income of $2,700. With an influx of migration from rural areas, this segment is expected to double by 2025. The Rural segment of approximately 900 million people has an average income of $1,050 per year. A further segmentation by state shows that the capital city, Delhi has the highest average income in the Urban segment, followed by Maharashtra and Madhya Pradesh. In the Rural segment, the highest earning state is Punjab, followed by Andhra Pradesh, Kerela and the Himalayan States.

Fig 8.10 Average Income by State

Source: IIMS DataWorks
9. Multi-asset funds

9.1 Introduction to multi-asset investing

Multi-asset funds invest in a broad range of asset classes including, but not limited to, Equities, Fixed-income, Real estate, Commodities and Alternatives. They derive their value from providing diversification and risk-adjusted returns, and have gained in popularity worldwide over the past few years. These funds provide the advantage of gaining exposure to different asset classes, while also providing an efficient way of hedging in turbulent market conditions. Although limited exposure to asset classes could result in investors not being able to capitalize on bull runs in one or more asset classes during a particular time period, they limit investors’ exposure in severe downturns and periods of financial instability, such as the recent sub-prime crisis.

The recent volatility in financial markets and downward pressure on interest rates has prompted investors to seek more and more diversification of their portfolios. There has been an evidenced flight to safety and quality by investors, who are seeking to not only diversify across geographic boundaries, but also across asset classes. The idea behind multi-asset funds, however, is not just diversification, but also professional fund management. They can either be used to create a diversification tool for the entire portfolio, or form part of an already diversified investment portfolio. While many sector-focused fund managers have traditionally sought to diversify within asset classes, high correlations in times of high volatility have made the case for diversification across asset classes even stronger. By dynamically changing allocations across asset classes, multi-asset fund managers seek to increase returns, while adjusting for risk. While some fund managers in this class are market neutral, others perform strategic allocations according to their long term macroeconomic projections.

9.2 Performance metrics

The performance of strategies employed by fund managers over the past ten years globally can give us some idea of the value of multi-strategy funds. These funds have clearly generated the highest risk-adjusted returns, evidenced by the highest Sharpe Ratio of 2.01. Their best monthly return, at 4.34%, is much lower than that for other strategies, illustrating the point that they may
underperform other strategies during bull runs in one or more asset classes. The 12.04% annualized return of multi-strategy funds, as reported by the Eurekahedge Hedge Fund Index, has been among the highest across all strategies. Hence, these funds have not only shown high returns, but also lower risk over the past ten years.

Table 9.1 Performance metrics of Hedge Fund Strategies

<table>
<thead>
<tr>
<th>Key Statistic</th>
<th>Arb</th>
<th>CTA</th>
<th>Dist. Debt</th>
<th>Event Driven</th>
<th>Fixed Income</th>
<th>Long Short</th>
<th>Macro</th>
<th>Multi-strategy</th>
<th>Avg.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annualized Return %</td>
<td>8.6</td>
<td>12.06</td>
<td>12.07</td>
<td>11.45</td>
<td>8.88</td>
<td>9.67</td>
<td>10.47</td>
<td>12.04</td>
<td>10.68</td>
</tr>
<tr>
<td>Annualized Standard Deviation %</td>
<td>3.6</td>
<td>7.91</td>
<td>6.99</td>
<td>7.00</td>
<td>4.00</td>
<td>7.9</td>
<td>4.5</td>
<td>4.98</td>
<td>5.7</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>1.83</td>
<td>1.27</td>
<td>1.44</td>
<td>1.35</td>
<td>1.72</td>
<td>0.98</td>
<td>1.9</td>
<td>2.01</td>
<td>1.6</td>
</tr>
<tr>
<td>Best Monthly Return %</td>
<td>2.76</td>
<td>8.54</td>
<td>5.81</td>
<td>6.51</td>
<td>3.34</td>
<td>9.21</td>
<td>6.17</td>
<td>4.34</td>
<td>5.63</td>
</tr>
<tr>
<td>Worst Monthly Return %</td>
<td>-5.98</td>
<td>-4.55</td>
<td>-9.48</td>
<td>-8.3</td>
<td>-6.79</td>
<td>-6.9</td>
<td>-1.98</td>
<td>-5.31</td>
<td>-5.87</td>
</tr>
<tr>
<td>2009 Return %</td>
<td>21.5</td>
<td>2.83</td>
<td>32.9</td>
<td>38.17</td>
<td>21.77</td>
<td>23.64</td>
<td>12.7</td>
<td>20.5</td>
<td>21.5</td>
</tr>
<tr>
<td>2010 Return %</td>
<td>4.01</td>
<td>1.97</td>
<td>7.98</td>
<td>3.92</td>
<td>6.34</td>
<td>-0.39</td>
<td>2.32</td>
<td>2.43</td>
<td>3.5</td>
</tr>
<tr>
<td>Rise in NAV Since Inception</td>
<td>140.9</td>
<td>236.9</td>
<td>237.3</td>
<td>217.8</td>
<td>147.9</td>
<td>167.6</td>
<td>189.1</td>
<td>236.0</td>
<td>197.0</td>
</tr>
</tbody>
</table>

Source: Eurekahedge
9.3 Multi-asset funds in India

Multi-asset funds are a new category in the Indian AMC industry. Their demand is driven by investors’ desire to gain exposure to the various burgeoning asset classes in India, apart from the equity markets. The AMC space has traditionally been dominated by equity and income related schemes, currently at 56% and 27% of AUM respectively. Balanced funds, which offer exposure to Equities and Debt typically in a 60:40 ratio, have a very small proportion of industry AUM at a mere 3%.

Evolving economic conditions in India over the past decade have caused shifts in investor preferences. High volatility of returns for most asset classes has resulted in a growing proportion of total investments being channelized toward bank fixed deposits from 36.5% of total financial assets in 2005 to 54.9% in 2009. Government securities on the other hand have seen a decrease in popularity. Life insurance products have also steadily increased their market share, while allocation toward pension funds has gradually declined. Participation in the equity markets had increased to its highest level of 12.5% in 2008 followed by a sharp drop. Hence we can see that allocation has evolved over the past years as investors look to capitalize on rising asset prices, albeit shying away from price volatility. Multi-asset products will be able to provide customized and optimal allocation that maximizes risk-adjusted returns and hence become a favored choice for investors looking to gain exposure to a range of asset classes.

Fig 9.1 Evolving Asset Allocation

![Evolving Asset Allocation Graph](source: SEBI)
Over the past two years, a select number of multi-asset funds have been launched in India in the Mutual Fund space, targeted primarily toward retail investors. Although the major asset classes invested by these funds are Equities, Debt and Gold, some AMCs are bringing other assets into their product mix. At present, the major AMCs offering multi-asset mutual funds are Canara Robeco, Kotak Asset Management and Axis Mutual Fund. Aegon has recently announced that it will launch a multi-asset fund that will go beyond these three asset classes and also include Commodities and Index-linked securities. The fund will target a 10% annual return irrespective of market conditions, once again emphasizing the growing demand for diversification and protection in a volatile investment climate.

Table 9.2 Multi-asset Funds in India

<table>
<thead>
<tr>
<th>Name</th>
<th>Equity</th>
<th>Debt</th>
<th>Gold</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canara Robeco Indigo Fund</td>
<td>0%</td>
<td>65-90%</td>
<td>10-35%</td>
</tr>
<tr>
<td>Kotak Multi Asset Allocation Fund</td>
<td>5-20%</td>
<td>75-90%</td>
<td>5-20%</td>
</tr>
<tr>
<td>Axis Triple Advantage Fund</td>
<td>33%</td>
<td>33%</td>
<td>33%</td>
</tr>
</tbody>
</table>

Source: Economic Times

While some AMCs are expected to follow suit, more cautious fund managers may be waiting to see the demand for such funds before they venture into this space. Early mover advantage could hence be key, due to the significance of establishing brand names in the industry. Of the four major funds mentioned above, two have been launched in 2011, illustrating the potential to gain a competitive advantage, early, before the space gets flooded with similar product offerings. Domestic and overseas AMCs have the opportunity to not only offer new funds targeted toward multi-asset strategies, but also increase the variety of assets they offer beyond the Equity, Income and Gold focus.

In the hedge fund space, multi-strategy funds have traditionally been Fund of Funds and there is no significant player focusing specifically in a multi-asset strategy. Since the above mentioned funds are targeted toward the retail investor, the options for the HNI and Institutional investor segments wanting to gain exposure to a variety of asset classes are very limited. In January 2011, Karvy Private Wealth, a 25 year old wealth management company in India, launched a first of its

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46 Aegon sets up multi-asset fund for retail investors, Reuters, 2011
kind multi-asset product targeted toward the HNI segment. The "Aries" fund will focus on Equity and Gold related products and seeks to return 10% annually to its investors. The somewhat lower target return, when compared with other fund strategies in India, can be attributed to the fund offering total capital protection and hence more biased toward capital preservation than growth. Another asset manager looking to capitalize on the potential in the multi-asset space for HNIs and institutional investors is Credit Suisse through the launch of its Multi-asset Class Solutions (MACS) in India, in 2008. MACS has a worldwide presence with over $175 billion under management across different geographies. In February 2011, Credit Suisse Asset Management reached an agreement with HDFC AMC for exclusive distribution of their products.
10. Selected Asset Classes for Multi-asset Funds

Before designing multi asset portfolios for the Indian market, we first identify the asset classes to be included. It is important to understand the intrinsic risk and return characteristics of these asset classes. The risk and return parameters calculated are for the preceding five years, based on monthly returns beginning January 2006. Correlations of monthly returns of these asset classes are also calculated in order to provide better optimization. While these portfolios are aimed to provide absolute returns, we also identify a benchmark to compare the risk and return characteristics.

10.1 Benchmark

The benchmark identified in this report is the Bombay Stock Exchange Sensitive Index. It is the widely used index to represent the Indian equity markets. The BSE Sensex is a value weighted index of the 30 largest and most actively traded stocks on the Bombay Stock Exchange. The base price of the BSE Sensex is 100 and the base year is 1979. The index price, calculated on a free-float market capitalization method, reached its peak of 21,078 points on January 8th, 2008, more than doubling in value within the preceding two years. Currently, the market capitalization of the BSE Sensex is approximately $600 billion. Over the past five years, the BSE Sensex has given average monthly returns of 1.45% with a monthly Standard Deviation of 9.03%. The index’s annualized return since January 2006 is 17.44% with an annualized Standard Deviation of 31.30%. The value of $1 invested in the BSE Sensex in Jan 2006 was $1.92 as of March 2011.

Fig 10.1 BSE Sensex (Jan 2006 – Mar 2011)

Source: Thompson Reuters DataStream
Although multi-asset portfolios can comprise of any combination of assets, for the purpose of this paper, the following five asset classes have been selected. It is also possible to further subdivide these asset classes, however for simplicity and for ease of illustration, the major five categories are used. The selected assets are not only among the most popular asset classes traded worldwide, but also have the highest liquidity and hence lowest transaction costs, enabling dynamic allocation with lower costs. The key statistics used to understand the risk and return characteristics of the below listed asset classes are:

- Expected Return – Estimated from historical data
- Standard Deviation – Estimated from historical data
- Value of $1 invested in January 2006
- Correlation with the benchmark
- Beta – Calculated using \( \beta_i = (\rho_{im} \sigma_i) / \sigma_m \)
  where \( \rho_{im} \) is the correlation between the asset and the benchmark

### 10.2 Equity

The National Stock Exchange of India (NSE) is the 9\textsuperscript{th} largest stock exchange in the world, with a market capitalization of $1.59 trillion as of December 2010. It currently has a listing of 1,552 companies. The NSE’s primary index, the S&P CNX Nifty is used to represent the Equity asset class in this report. The “Nifty” includes 50 companies representing 23 diversified sectors, accounting for approximately 60% of the NSE’s market cap, and is a key representation of the Indian equities markets. The Nifty’s base value is 1000 and base date is November 1995.
Over the past 5 years, the Nifty has given average monthly returns of 1.45% with a monthly Standard Deviation of 8.58%. The annualized return is 17.35% with an annualized Standard Deviation of 29.73% and a Sharpe Ratio of 0.34. The value of $1 invested in the Nifty in January 2006 was $1.94 as of March 2011. The Nifty’s Beta with the market is 0.82.

Source: Thompson Reuters DataStream
10.3 Real Estate

To recognize the increasing demand for investments in India’s burgeoning Real Estate sector, the Bombay Stock Exchange launched its BSE Realty Index in 2007, with 2005 as the base year and base index price at 1000 starting from January 2006. The Index currently comprises of India’s 15 largest real estate companies and is a good representation of the sector. The Index grew from its base price of 1,000 to a peak of over 13,000 points within two years, however with a sharp decline thereafter.

Fig 10.4 BSE Realty Index (Jan 2006 – Mar 2011)

India’s Real Estate sector, as represented by the BSE Realty Index, has been extremely volatile over the past five years. While average monthly returns have been very high at 2.99%, monthly Standard Deviation has also been extremely high at 22.45%. Annualized return over the same period was 35.87% with annualized Standard Deviation at 77.78%, illustrating the sector’s extreme volatility. The Sharpe Ratio is 0.37. The value of $1 invested in the Index in January 2006 was $1.52 as at March 2011, having peaked at $9.71 in January 2008. High volatility has also resulted in a high Beta of 1.92.
10.4 Commodities

While Gold has been a commodity of choice for Indian investors, including a wider Commodity asset class with a basket of commodities extending beyond Gold not only improves diversification, but also provides exposure to the increasing prices of all commodities in India. The Multi Commodity Exchange (MCX) of India was established in 2003. It offers futures trading in Metals, Energy, Bullion and Agricultural commodities. MCX is the world’s 6th largest commodity exchange in the number of contracts trades with an annual turnover of $1.24 trillion in 2009. The MCX Commodities Index (Comdex) is the only commodities price index in India and usually represents the country’s commodities market.

Source: Multi Commodity Exchange of India
The commodities market has been on average less volatile than other asset classes with a lower average monthly returns of 1.30% accompanied by lower monthly Standard Deviation of 5.99%. The annualized returns since January 2006 have been 15.63% with annualized Standard Deviation of 20.74%. Commodities have returned a slightly higher Sharpe Ratio of 0.40 than other asset classes and a far lower Beta of 0.24, illustrating their lower risk profile than assets such as Equities or Real Estate. The value of $1 invested in the MCX Comdex in January 2006 was at $1.85 as at March 2011.

**Fig 10.7 MCX Comdex Cumulative vs. Monthly Returns**

![Graph showing cumulative vs. monthly returns for MCX Comdex]

*Source: Multi Commodity Exchange of India*

### 10.5 Hedge Funds

While Hedge Funds are still at a nascent stage in India, including the asset class in multi asset portfolios allows all types of investors to gain exposure to the projected industry growth. Although historically a large majority of hedge funds in India have been equity focused, an evidenced move toward multi-strategies makes investment in Hedge Funds a source of diversification as well as capitalizing on potentially high returns. The Eurekahedge India Hedge Fund Index with 29 constituents is a barometer of the performance of this asset class. The base year for this Index is 1999, with a base value of 100.
Fig 10.8 Eurekahedge India Hedge Fund Index (Jan 2006 – Mar 2011)

Although the Hedge Fund Index had surged to a high above 200 points in January 2008, returns over the past five years have been lower than asset classes such as Equity and Commodities. Average monthly returns were 1.12% with monthly Standard Deviation of 6.84%. Annualized returns were 13.50% and annualized Standard Deviation was 23.70%. The value of $1 invested in the Hedge Fund Index in January 2006 was at $1.36 as at March 2011. Hedge Funds have returned a Sharpe Ratio of 0.24 and a Beta of 0.64. An expected influx of overseas fund managers is expected to see returns grow over the next few years and including Hedge Funds in multi asset portfolios can give a limited exposure to this asset class.

Fig 10.9 Eurekahedge India Index Cumulative vs. Monthly Returns

Source: Eurekahedge

Source: Eurekahedge
10.6 Treasuries

Prevailing high interest rates make investments in government treasuries very lucrative due to their risk free nature. Government securities in India are registered with the Public Debt Office (PDO) of the Reserve Bank. Investments can be made either physically or in dematerialized form and securities are traded either OTC or through a Negotiated Dealing System (NDS). Government securities have dominated the Bond markets at a staggering 40% of GDP as compared to only 2% of GDP for Corporate Bonds. The institutional investor segment, especially pension funds and life insurance products have driven demand for these securities. Currently, the 91-day T-bill carries a yield of 7.31% (as at March 15, 2011). Over the past five years, the 91-day T-bill has an average annual yield of 5.72%.

Fig 10.10 91-day T-bill Yield % (Jan 2006 – Mar 2011)

Source: Thomson Reuters DataStream
## 10.7 Comparison of Risk/Return Metrics

Table 10.1 Key Statistics of Selected Asset Classes

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Average Return (Annualized)</th>
<th>Average Standard Deviation (Annualized)</th>
<th>Value of $1 invested in Jan 2006</th>
<th>Sharpe Ratio</th>
<th>Beta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>17.35%</td>
<td>29.73%</td>
<td>$1.94</td>
<td>0.34</td>
<td>0.82</td>
</tr>
<tr>
<td>Real Estate</td>
<td>35.87%</td>
<td>77.78%</td>
<td>$1.52</td>
<td>0.37</td>
<td>1.92</td>
</tr>
<tr>
<td>Commodity</td>
<td>15.63%</td>
<td>20.74%</td>
<td>$1.85</td>
<td>0.40</td>
<td>0.16</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>13.50%</td>
<td>23.70%</td>
<td>$1.44</td>
<td>0.26</td>
<td>0.64</td>
</tr>
<tr>
<td>Treasuries</td>
<td>5.72%</td>
<td>-</td>
<td>$1.37</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Comparing the risk/return metrics of the above listed asset classes, we can see that while Equity, Commodities and Real Estate have different return and standard deviations, their risk adjusted returns are very similar, evidenced by similar Sharpe Ratios. The choice of investment hence depends on the investor’s level of risk aversion. Using data from the previous five years, we can determine the regression line, which has the equation:

\[ y = 0.38x + 0.056 \]

Both Real Estate and Equity lie on the regression line, while Commodities have outperformed the other asset classes in risk-adjusted returns. The regression analysis also shows a very high dependence of asset returns on volatility, evidenced by an R-squared very close to 1. Investors have hence been able to target higher returns by increasing their risk appetite. Hedge Funds have underperformed as they have not been able to provide returns associated with their level of volatility, with a very low Sharpe Ratio of 0.24. The Beta of Commodities is the lowest, illustrating that they have been the safest of the four assets selected, with Real Estate being the riskiest with a high Beta of 1.94.
The flow of funds toward asset classes has been affected by the perception of risk of the respective asset. One of the primary reasons for low participation of retail investors in the equity markets has been the high volatility associated with returns. For the period between 2003 and 2006, the BSE Sensex was the second most volatile of all major stock market indices of the world, after the Russian IBOV. However since then, even though volatility has still remained high, other indices in Asia such as the Hong Kong HSI and Japanese NIKKEI have shown even higher volatility in daily returns. In 2009, the standard deviation of daily returns of the BSE Sensex was approximately 3%.

Source: SEBI
Historically, this high volatility of returns has led to increased resource mobilization of Asset Management Companies. High risk associated with equity returns causes investors to redeploy funds towards investments that carry lower risk. With the exception of 2009, when high volatility in the equity markets was accompanied by low resource mobilization by AMCs, the past decade has seen a positive relationship between volatility and AMC resource mobilization.

![Fig 10.13 AMC Resource Mobilization and Stock Market Volatility](image)

Source: SEBI

The above trend further emphasizes the value of multi-asset funds as investors seek investments that provide superior risk adjusted returns in times of high volatility of equity markets.

Apart from determining the characteristics of return and volatility, for the purpose of building multi-asset portfolios, it also important to calculate the correlation of returns between the selected asset classes. Following is the correlation matrix of the four risky assets and the risk free asset, showing the correlations of monthly returns since January 2006.

### Table 10.2 Correlation Matrix

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Treasuries</th>
<th>Equity</th>
<th>Real Estate</th>
<th>Commodity</th>
<th>Hedge Funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasuries (Risk free)</td>
<td>1.00</td>
<td>-0.28</td>
<td>-0.24</td>
<td>-0.12</td>
<td>-0.32</td>
</tr>
<tr>
<td>Equity</td>
<td>-0.28</td>
<td>1.00</td>
<td>0.77</td>
<td>0.24</td>
<td>0.85</td>
</tr>
<tr>
<td>Real Estate</td>
<td>-0.24</td>
<td>0.77</td>
<td>1.00</td>
<td>0.20</td>
<td>0.80</td>
</tr>
<tr>
<td>Commodity</td>
<td>-0.12</td>
<td>0.24</td>
<td>0.20</td>
<td>1.00</td>
<td>0.34</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>-0.32</td>
<td>0.85</td>
<td>0.80</td>
<td>0.34</td>
<td>1.00</td>
</tr>
</tbody>
</table>
The above matrix shows that Commodities are least correlated with other assets, hence making the asset class a valuable component of diversified portfolios. The strongest correlation is evidenced between Hedge Funds and Equity. This strong relationship shows the heavy bias of Indian Hedge Funds on Long-only equity strategies. While this was the case in the past, an evidenced shift toward multi-strategies by hedge fund managers is expected to lower this correlation and hence make hedge funds a valuable component of multi-asset portfolios. The correlation between Equity and Real Estate is also high as the index used to represent the Real Estate sector is based on the equity prices of the largest Real Estate companies. The recently launched Real Estate Sensitivity index (RESSEX) can be used in the future to represent the sector, once data is available for a significant time period. The above listed correlations will be of significant use in determining asset allocation in the next section.
11. Portfolio Allocation

After having understood the risk and return metrics of the asset classes to be included in the multi asset portfolio, the next step is to design model portfolios that provide superior risk adjusted returns than the benchmark as well as the other asset classes, hence illustrating the value added of multi-asset portfolios. The model used is based on the Markowitz-Tobin portfolio choice framework, which assumes that investors are mean/variance optimizers and that they focus on their end-period wealth and not the separate performance of their portfolio components.47 Investors are hence indifferent between portfolios that have the same expected return and standard deviation. For this purpose, a model using a combination of the risk free asset and the Optimal Combination of Risky Assets (OCRA) is used. The OCRA assumes that the market portfolio is not the efficient portfolio and we can obtain superior performance through a combination of assets, which will provide a return that does not satisfy the CAPM Security Market Line (SML). The deviation from the SML is our portfolio Alpha. A graphical explanation of the OCRA is shown below:

Fig 11.1 Graphical Representation of the OCRA

47 Continuous-time Finance, Robert C. Merton, 1990
The risk/reward tradeoff line represents the basic principle that the more risk we are willing to take, higher the reward will be. However, this also increases the probability of loss. The Markowitz-Tobin framework allows us to increase or decrease our expected return depending on our willingness to take risk. As we move along the risk/reward line, the percentage risk of the portfolio keeps increasing to point D, which is the point of maximum risk of the OCRA. The optimal portfolio return is at point A, which is a combination of the risk free asset and the risky assets. This risk level associated with this portfolio is represented by point B. We can increase our return by investing only in the OCRA (without the risk free asset) along the same risk/reward frontier to any point between A and C. As the reward tends toward point C, the risk tends toward point D. The slope of the risk/reward frontier is determined by the points A and B, and the intercept is at the risk-free rate.

The OCRA model is based on the Expected Return and Expected Standard Deviation of each asset class, which have been determined in the previous section. The basis of the model is to build a portfolio that consists of the previously selected risky assets and the risk free asset. We can vary the amount of risk (and consequently the return) by varying asset allocation. Additionally, the model also provides for the correlation between returns of each set of asset classes, as detailed in the afore-stated correlation matrix. Since the purpose of determining the optimal portfolio is to maximize risk adjusted returns, the portfolio’s Sharpe Ratio is set as the value to be maximized. In doing so, we will be able to determine a target Sharpe Ratio for optimal portfolios and adjust the portfolio weights to increase or decrease the expected return according to the investor’s risk preference. We can move further along the risk/reward line with the use of leverage, however for the purpose of this paper we assume that no leverage is used.

The inputs of the model are:

- Expected Return of the Risk-free Asset – 91-day Govt. of India T-bills
- Expected Return of the Risky Assets – Estimated using historical data
- Standard Deviation of the Risky Assets – Calculated from historical data
- Constraints of allocation per asset – These can vary between 0% and +100%
- Correlation of returns between asset classes – As described in Table 10.2
The outputs of the model are:

- Percentage allocation to each asset in the optimal portfolio
- Percentage allocation of the OCRA
- Expected return of the portfolio
- Standard deviation of the portfolio
- Sharpe ratio of the portfolio
- Beta of the portfolio
- Risk/reward tradeoff line

To achieve the above explained combination, we first assume that the correlations between asset returns are zero. Doing so will enable us to illustrate the effect of correlations on the optimal portfolio. We also assume that the portfolio is Long-only and hence the minimum allocation for each asset is set to zero. The characteristics of this optimal portfolio are as follows:

**Table 11.1 Key Statistics for the Optimal Portfolio (without correlation)**

<table>
<thead>
<tr>
<th>Optimal Portfolio Asset</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasuries</td>
<td>3.8%</td>
</tr>
<tr>
<td>Equity</td>
<td>22.0%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>9.1%</td>
</tr>
<tr>
<td>Commodity</td>
<td>39.9%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>25.2%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OCRA Asset</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>22.8%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>9.5%</td>
</tr>
<tr>
<td>Commodity</td>
<td>41.5%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>26.2%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Key Statistic</th>
<th>Portfolio</th>
<th>Benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected Return</td>
<td>17.00%</td>
<td>17.44%</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>13.69%</td>
<td>31.30%</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.71</td>
<td>0.32</td>
</tr>
<tr>
<td>Beta</td>
<td>0.34</td>
<td>1</td>
</tr>
<tr>
<td>Value of $1 invested in Jan 2006</td>
<td>$2.02</td>
<td>$1.91</td>
</tr>
<tr>
<td>Maximum Positive Monthly Return</td>
<td>16.59%</td>
<td>23.68%</td>
</tr>
<tr>
<td>Maximum Negative Monthly Return</td>
<td>-16.58%</td>
<td>-24.38%</td>
</tr>
</tbody>
</table>
The long only portfolio, without accounting for correlations, gives a return very close to that of the benchmark, however with much lower volatility and hence a higher Sharpe Ratio. Risk adjusted returns are therefore much higher. This is illustrated by the high percentage allocated to commodities due to their low risk nature and the low percentage allocated to Real Estate, which despite high returns, has shown extreme volatility over the past five years. This portfolio provides a balanced exposure to all the asset classes and maximized the Sharpe Ratio at 0.71, more than double that of the benchmark. Comparing the portfolio’s maximum positive and negative monthly returns also illustrates the lower volatility achieved through diversification. While the above portfolio illustrates the benefits of diversification across asset classes, it is not realistic as it does not account for correlations between asset returns. Correlations tend to increase in times of crises and hence it is important to account for the relationship between asset returns. Similar to the above, an optimal portfolio is determined using the correlation matrix described in Table 10.2. The characteristics of this portfolio are as follows:

Table 11.2 Key Statistics for the Optimal Portfolio (with correlation)

<table>
<thead>
<tr>
<th>Optimal Portfolio Asset</th>
<th>Weight</th>
<th>OCRA Asset</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasuries</td>
<td>5.7%</td>
<td>Equity</td>
<td>30.55%</td>
</tr>
<tr>
<td>Equity</td>
<td>28.8%</td>
<td>Real Estate</td>
<td>8.20%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>7.7%</td>
<td>Commodity</td>
<td>50.64%</td>
</tr>
<tr>
<td>Commodity</td>
<td>47.7%</td>
<td>Hedge Funds</td>
<td>10.61%</td>
</tr>
<tr>
<td>Hedge Funds</td>
<td>10.0%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Key Statistic</th>
<th>Portfolio</th>
<th>Benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected Return</td>
<td>17.00%</td>
<td>17.44%</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>16.41%</td>
<td>31.30%</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.59</td>
<td>0.32</td>
</tr>
<tr>
<td>Beta</td>
<td>0.41</td>
<td>1</td>
</tr>
<tr>
<td>Value of $1 invested in Jan 2006</td>
<td>$2.23</td>
<td>$1.91</td>
</tr>
<tr>
<td>Maximum Positive Monthly Return</td>
<td>18.81%</td>
<td>23.68%</td>
</tr>
<tr>
<td>Maximum Negative Monthly Return</td>
<td>-16.60%</td>
<td>-24.38%</td>
</tr>
</tbody>
</table>
Accounting for the correlation between assets lowers the Sharpe Ratio from 0.71 to 0.59, illustrating the significance of the relationship between asset returns. The expected return obtained for this level of risk is the same as that of the previous portfolio, however with slightly higher volatility. The cumulative returns, nonetheless improve as the value of $1 invested in January 2006 for this portfolio is $2.23 in March 2011. The value added of the Commodities asset class in achieving diversification is evident as the allocation increases to 47.7%. This is because Commodities have a far low correlation with other asset classes, and close to zero correlation with Equities. On the other hand, Hedge Funds have shown high correlation over the past five years with the Real Estate and Commodities sectors and hence lose value in diversification, as the portfolio weight decreases to 10%.

**Fig 11.2 Cumulative Returns of Multi-asset Portfolio vs. Benchmark**

![Cumulative Returns Graph](image)

The combination of the OCRA with the risky asset above maximized the Sharpe Ratio and hence the risk-adjusted returns. After having calculated this optimal level, we can determine a range of target returns along the risk/reward line. For every level of risk represented by a certain Standard Deviation, we can obtain a target return along the line with equation:

\[ y = 0.579x + 0.0728. \]
Fig 11.3 Optimal Portfolio Risk/Reward Line

For every level of risk, the expected return of the multi-asset portfolio is higher than the benchmark as well as each individual asset class included.

The value of optimization can also be illustrated by comparing the cumulative returns generated by a portfolio that consists of an equal weighting of each asset class including the risk free asset. Following are the comparison metrics of the optimal portfolio with an equal weighted portfolio.

Table 11.3 Comparison of Optimal with Equal Weighted Portfolio

<table>
<thead>
<tr>
<th>Key Statistic</th>
<th>Optimal Portfolio</th>
<th>Equal Weighted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected Return</td>
<td>17.00%</td>
<td>16.64%</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>16.41%</td>
<td>22.38%</td>
</tr>
<tr>
<td>Sharpe Ratio</td>
<td>0.59</td>
<td>0.42</td>
</tr>
<tr>
<td>Value of $1 invested in Jan 2006</td>
<td>$2.23</td>
<td>$2.04</td>
</tr>
<tr>
<td>Maximum Positive Monthly Return</td>
<td>18.81%</td>
<td>21.98%</td>
</tr>
<tr>
<td>Maximum Negative Monthly Return</td>
<td>-16.60%</td>
<td>-23.37%</td>
</tr>
</tbody>
</table>

Hence we have determined that multi-asset portfolios that optimize the risk/reward frontier increase the value of investment through higher risk-adjusted returns. They control for downside volatility in uncertain market conditions while allowing exposure to returns across assets. The
above optimal portfolio is based on the assumption of static asset allocation. The portfolio weights have been kept constant in back-testing returns. However, a dynamic allocation could lead to even higher risk adjusted returns. Since the risk and return metrics used to optimize the portfolio were based on the previous five years’ data, the portfolio weights can be dynamically adjusted based on the expected return and standard deviation calculated for the trailing five years. Data for the Real Estate and Commodities asset classes was only available since January 2006 as the indices were launched then, and hence a dynamic allocation based on the trailing five years’ data was not possible. However, in the future, changing allocation on a quarterly or semi-annual period may add further value to the portfolio. Additionally, the optimal portfolio in this paper has been determined using indices to represent asset classes and hence a passive allocation has been performed. The OCRA model can be used to further optimize within the asset classes by subdividing them into smaller categories.
12. Competitive Strategy

12.1 Improved product offering

Homogeneity of the product mix has been a hallmark of India’s Asset Management industry. One of the reasons for this has been lack of investor literacy and hence a tendency to compete for the same market. However, growing levels of income and consequently increasing investment surplus has led to a demand for products that offer diversification and better risk management. Currently, income and growth strategies dominate the AMC market, accounting for 49% and 35% of AUM respectively. New product offerings have been rising rapidly but the product mix has remained somewhat stagnant. The recent financial crisis has also instigated a flight to safety and the timing is ripe to introduce products that offer risk adjusted returns. Multi-asset portfolios cater to this need as their value proposition is in both diversification and risk management. Introduction and widespread diffusion of these products will require AMCs to make a concerted effort toward investor education. The value-added of multi-asset funds can be illustrated by the following value curve:

![Fig 12.1 Value Proposition of Multi-asset Funds](image)

While a vast majority of the current product offerings score higher in their simplicity and upside return potential, multi-asset funds offer better diversification, innovation in product offerings, risk management as well as the value added by fund manager expertise. Although it would be
very difficult to compete with the established players with similar product offerings to theirs, success and leadership in the industry can be attained through altering industry standards and creating value through innovation and product design. Fund managers need to introduce new products to whet the appetite of new age investors. This can be understood further using a Four Actions Framework. Incorporating these changes to the industry standards will enable new firms to compete on product and distribution.

**Fig 12.2 Four Actions Framework**

- **Raise**
  - Investor literacy
  - Focus on product innovation
  - Investment in technology to streamline distribution

- **Create**
  - Better risk-adjusted returns from product offerings
  - Clear communication channels with clients to receive and incorporate feedback

- **Eliminate**
  - Homogeneity of product offerings

- **Reduce**
  - Administration and marketing costs

**12.2 Cost Management**

To establish and develop a sustainable business model, it is important to exercise efficient cost management. The major sources of costs for asset managers are distribution, marketing and manpower. One of the major reasons why AMCs have refrained from focusing distribution efforts in the smaller cities has been the high cost associated with reaching customers. Many new technological changes that have taken place over the past few years have helped enable cheaper diffusion, such as the rapid expansion of mobile technology. Currently, there are a staggering 500 million mobile users in the country, which is even higher than the number of people with basic bank accounts. AMCs have started taking notice of E-commerce and mobile technology channels, which will play a major role in distribution and marketing that is less costly and more efficient. Expenses as a percentage of AUM increased from 41 bps in 2003 to 113 bps in 2008.
With the new regulation disallowing entry loads for mutual funds, there is further downward pressure on profitability and efficient cost management will be a key factor going forward. Industry expense ratio increased from 1.4% in 2009 to 1.58% in 2010, further underscoring the need for cost management. While the larger AMCs are looking toward outsourcing of business processes, new players in the industry will have to rely on measures such as more targeted distribution in order to attain optimal utilization of resources.

12.3 Targeted Distribution

Targeted distribution is a key factor in not only creating widespread diffusion, but also ensuring efficient use of resources. Different segments of the markets have their own preferences in terms of selecting the channels through which they make their investments and an understanding of these preferences will allow for optimal utilization of channels. The importance of distribution can be illustrated through the value that is captured in this part of the industry value chain. Distributors enjoy 60% share of revenues generated by AMC products.

The first stage of the distribution effort for multi-asset funds needs to be targeted toward the top tier cities. Since these cities are ranked high in not only population density, but also income levels, focusing distribution efforts in these cities will enable creating product awareness, especially for offerings that incorporate strategies that investors may not be very well versed with. Moreover, investors in these cities are more open to alternative fund management products that expand beyond traditional mutual funds, due to higher investor literacy. This segment is projected to grow to 9.5 million households by 2025, accounting for 22% of the country's disposable income. The preference of investors in the largest ten cities for distribution channels can be broken down as follows:

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Table 12.1 Preferred Investment Channels for Investors in Top 10 Cities

<table>
<thead>
<tr>
<th>Preferred Channel</th>
<th>Percentage Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent Financial Advisors</td>
<td>29%</td>
</tr>
<tr>
<td>Public Sector Banks</td>
<td>17%</td>
</tr>
<tr>
<td>Multi-national banks</td>
<td>16%</td>
</tr>
<tr>
<td>Internet</td>
<td>14%</td>
</tr>
<tr>
<td>Brokerage Houses</td>
<td>11%</td>
</tr>
<tr>
<td>Private Banks</td>
<td>11%</td>
</tr>
<tr>
<td>Direct Investment</td>
<td>2%</td>
</tr>
</tbody>
</table>

Source: KPMG Research

From the above breakdown, it can be determined that IFAs, public sector banks, MNC banks and private banks should be used as the distribution channels in this segment. Even though private banks account for only 11% of the investment channels used by this segment, they have the highest cross selling rate for AMC products, at 8%. A high-quality, specialized sales force will be able to drive distribution efforts in this market segment. For overseas fund managers to market products through appointed banks, they are required by the Reserve Bank to do so in compliance with conditions fulfilled by the bank. This requirement for registering funds with the RBI is not applicable if the fund has less than 50 investors.

12.4 Financial Inclusion

While the Tier 1 cities should be used to enter the market, it is important to reach the Tier 2 cities, which heavily consist of the country’s rapidly growing middle class. This middle class is projected to grow to 600 million people by 2025 and account for over 40% of the country’s population. Even though ticket sizes will be smaller than the top tier, high volumes will enable revenue growth in this segment. The distribution channels preferred by this segment include public sector as well as private banks. Tier 3 cities are not yet suitable for multi-asset fund distribution as income levels are very low and investors tend to prefer instruments such as bank deposits and government savings schemes.

RBI defines tier 2 cities as those with a population base of 50,000 and above
12.5 Focus on investor preferences

Investor preferences in India are not just a function of risk and return but also idiosyncratic factors that must be considered before designing and implementing new product offerings. It is imperative to not only understand investor needs, but also the key drivers that help determine investment decisions. Typically, individual investors in India have a low risk/return profile, which has been further confirmed by fraudulent activity that has plagued the market over the years. Since the rationale behind portfolio construction is to provide investors with returns aligned with their preferences, adhering to investor objectives can be a significant source of gaining competitive advantage. Following is the hierarchy of investor needs in their decision making process while selecting asset management products:\(^{50}\)

![Fig 12.3 Hierarchy of Investor Preferences](image)

In line with their low risk/return profile, Indian investors rank “Safety” of investment as their top priority in making investment decisions and “Capital Appreciation” is a distant third. High volatility of returns has kept many investors from channelizing returns toward the capital markets. Products that provide investors with their most important needs will be able to capture

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\(^{50}\) An Investor’s requirements in Indian Securities Markets, Delhi Business Review, June 2007
market share. Multi-asset products fit into this category as they focus on risk-adjusted returns, which are becoming the need of the hour.

When developing strategies for the implementation of new products in the asset management space, it is also equally important to understand specific factors that help investors in their decision making process. The key attributes that investors seek from AMC products are listed below:51

- Past performance
- Brand name
- Portfolio of investments
- Ease of funds withdrawal
- Reputation of fund manager
- Tax benefits
- Product innovation
- Ratings
- Entry and exit loads
- Expense ratio

12.6 Brand Management

Together with past performance, brand name is a key component of investors’ decision making process in India. To attain widespread diffusion, the best strategy is to establish distribution partnerships with established players, specifically large banks. Since new firms in the market will not have the luxury of illustrating their past performance to influence investor decision-making, brand name will be of supreme significance. Co-branding of product offerings will enable leveraging the established distribution networks of the partner firm. A report published by McKinsey & Co. in 2010 showed that a positive perception of a financial service provider’s brand name in India induces a positive view of performance, hence making brand management extremely vital especially for new firms. In selecting which banks to approach for potential partnerships, it is useful to analyze the preferences of each investor segment on the basis of income group and geographic location, as detailed in earlier sections. The Employed segment in India has shown the use of Banks to purchase AMC products the most, at 30%, while the Business segment relies heavily on Independent Financial Advisors, at 76.7%. After having established a co-branding relationship, concerted marketing efforts can be made through these preferred channels in order to drive sales.

51 CII-KPMG Voice of India Survey
13. Conclusion

This paper began with background information, including all the key economic indicators and statistics of the Indian economy and the country’s Asset Management Industry. The analysis was essential to understand the state of the Indian economy and the industry in question. An attempt was made to segment the market in order to ensure optimal utilization of resources when applying marketing and distribution strategies. While an effort was made to design a model optimal portfolio incorporating the risk and return characteristics of selected asset classes, more efficient optimization can be achieved by further segmenting the asset classes and dynamically changing portfolio weights with evolving performance metrics. Finally, the key value drivers of a competitive strategy were analyzed in order to succeed in an otherwise competitive environment. The opportunity to achieve competitive advantage in providing multi-asset investment solutions to the Indian market exists, and it is incumbent upon savvy investment managers to seize the initiative early, and align their strategies with the needs of the Indian investor, providing bespoke solutions that offer risk management with superior performance.
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