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Should you invest in US-focused funds?

Though such funds offer diversification and counter the ills plaguing the Indian market, the returns are likely to be moderate in the long term.

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Have you been worried by the constant and unprecedented plummeting of the rupee, poor performance by India Inc, the worsening growth outlook, and the impending general elections next year? As an equity investor, you cannot be blamed for being concerned, and neither are you alone. With most people wondering what to do about their investments, a good option could be reaching out to the US. “Here’s an economy that is recovering, a market that is booming, and a currency that is strengthening. In other words, it’s the perfect antidote to the ills that are plaguing the Indian markets,” says a Delhi-based financial planner. The easy way to exploit this opportunity is to invest in the US- focused mutual funds.

Why invest in the US market

An investment in the US market offers geographic diversification. Since different markets outperform at different points of time, investors needs to diversify. Moreover, the Indian market belongs to the emerging market basket, while the US market falls in the developed market category. The two may not be negatively correlated or as decoupled as was suggested in the past, but they tend to have different levels of volatility, the US market being less volatile.

Investing in the US equities is not just about betting on the country, but on the global economic growth as well. “Most leading American companies get over 50% of their revenue from non-US markets, which makes them global,” says Sankaran Naren, chief investment officer, ICICI Prudential Mutual Fund.

In fact, no investor aspiring to build a global portfolio can afford to ignore the US equities. Says Pankaj Sharma, EVP, DSP BlackRock Investment Managers: “The US equities constitute almost 50% of all major global indices and form an integral part of most global investors’ portfolios.” The American market, the world’s largest, accounts for about 34% of the total global market capitalisation (India accounts for only around 2%).

Investing in the US also gives you access to the world’s largest economy. At $15 trillion, it accounts for 21.67% share of the world GDP. India’s GDP is a meagre $1.84 trillion.

Besides, Indian investors can gain exposure to several themes that are just not available within the country, such as defence, aerospace, semiconductor, toys and e-commerce services.

An exposure to the American market also provides a currency hedge. According to Aashish P Somaiyaa, chief executive officer, Motilal Oswal AMC, “Many of your financial goals, such as foreign education, vacation abroad and cost of fuel are dollar-denominated. Even though you may save a lot in rupee terms, you may fail to meet some of these goals as the rupee’s depreciation would work against you.” This depreciation, which has acquired alarming proportions in recent times, is also a long-term trend.

Lastly, the recovery within the US economy appears to be on a firmer footing now. The US housing sector is recovering. This will lend an impetus to consumption since the US households have most of their wealth tied up in realty. Says Nandkumar Surti, MD and CEO, JP Morgan Asset Management: “The economic recovery in the US has been going on for some time and is likely to consolidate. However, the GDP growth rate is still below the long-term trend level, so the recovery is likely to gather pace in the coming months.”

The US corporates are also in a strong position. The availability of shale gas has given them the advantage of low cost of energy. With inflation staying range-bound, labour cost in the US has been under control; it currently enjoys a 30-40% labour cost advantage over its OECD peers. Productivity within the US economy has also been on the rise. The American corporates also have a lot of cash on their balance sheets. Due to all these advantages, a number of US multinationals are planning to shift their manufacturing back home.

Caveats

The people investing in US-focused funds should have moderate expectations. Though the American market has done very well this year, in the longer run, returns are likely to be moderate. According to Raghvendra Nath, managing director, Ladderup Wealth Management, the US market has performed well in the past few years because it was recovering from the past lows. The QE3 programme has infused a large amount of liquidity, which has driven up the market. “Over 7-10 years, the likely investment horizon of an equity investor, a mature market like the US may not be able to beat the returns from emerging markets, where economic growth is likely to be faster,” he says. Nath also warns that after rallying since 2009 (except in 2011), valuations within the the US market may be high. However, whether the US market is already overvalued will depend on the economic recovery. If it continues, the market may move up. If it falters, it will prove expensive.

How much should you allocate?

At least 15-20% of your equity portfolio should be invested in international equities. Of this, you may allocate 50% to the US equities (the only developed market for which funds are available), and the rest to emerging market equities outside India. Vishal Dhawan, chief financial planner at Mumbaibased Wealth Ahead Advisors, suggests that you should split your US market allocation between a passive and an active fund.

More choices

If you wanted to invest in the US market via mutual funds a couple of years ago, you would have been starved for choice. However, now, five funds are available. You can invest in three feeder funds, wherein the Indiabased fund invests in a US-based mother fund. Feeder funds offer a couple of advantages. They come with a long-term track record which you can check. They also usually have a large corpus. “Even if the Indian feeder fund does not manage to raise a large corpus, it does not matter. Since the mother fund would already have a large corpus, it is not likely to be neglected by the fund house, as could happen in the case of small funds,” says Dhawan.

The mother fund also brings to the table the experience of the fund manager and the research team. Says Jaya Prakash K, director, global research and analytics, Franklin Templeton Investments: “Such expertise comes in handy in mitigating some of the risks associated with global investing.”

The disadvantage of feeder funds, however, is that you have to pay the expense ratio twice over, once for the mother fund and once for the Indian fund, which drives up their cost.

Also available now is a passive fund (from Motilal Oswal). This fund offer exposure to a broad index (in this case, the Nasdaq-100). Its biggest advantage is its low cost. If you are a proponent of value investing, J P Morgan’s fund that has just been launched offers you that option.

The Indian investors tend to worry whether they have invested in the right fund. According to Somaiyaa of Motilal Oswal AMC, they should be more concerned about being invested in the right asset classes. “Alpha comes from being in the right beta. Have exposure to all the significant asset classes, such as equity, debt, real estate and gold. Within equity, you should have exposure to both Indian and international equity,” he says. Somaiyaa cites the following example. This year, while the Indian market is flat yearto-date, the US market is up about 20%. “Even if you are invested in the best Indian fund, it may not match the returns from the US market,” he says. Hence, if you have the requisite risk appetite and a reasonably large-sized portfolio, invest a portion of it in US-focused funds.

FT India Feeder Franklin US Opportunities

AUM: 220.36 crore **Expense ratio:** 1.77%

This is a feeder fund that invests in the Franklin US Opportunities Fund. The parent fund invests in high-quality, growth companies with sustainable, long-term growth prospects. The stocks also demonstrate superior profitability and competitive advantages. The fund has the freedom to invest in large-, medium- and small-cap stocks. It is benchmarked against the Russell 3000 Growth Index. The parent fund has been in existence since April 2000. Its returns over the one-year, five-year, and 10-year horizons, in dollar terms were 17.53%, 5.35%, and 8.85%, respectively, as on 30 June. The benchmark returns for the same periods were 17.56%, 7.58% and 7.57%, respectively. While the fund has performed at par with its benchmark over the one-year horizon, it has lagged behind over the five-year period and has beaten it over the 10-year horizon. The feeder fund's return has been high. Since January 2012, it has given a return of 32%, aided by the rupee's depreciation.

JP Morgan US Value Equity Offshore Fund

AUM: 125 crore (NFO) **Expense ratio:** NA%

This feeder fund has just been launched and its parent is a value fund, a style of investing that is more popular and wellentrenched in the US market than in India, where the majority of funds are growth-oriented. While the fund manager looks at traditional valuation parameters, such as price-to-earnings ratio, price-to-book value ratio, and free cash flow-to-enterprise value, he also considers stocks that have displayed consistency in earnings, high return on capital employed, relatively low cyclicality in both business and earnings, and visibility in cash flows.

The parent fund's manager has 32 years of experience, all with JP Morgan. He has been managing this fund since its inception. In the US, JP Morgan manages equity assets worth $157 billion. Of this, $37 billion is managed under the value strategy. The parent fund has a corpus size of about $3 billion. It is benchmarked against the Russell 1000 Value Index. The mother fund has beaten its benchmark in all time horizons except one.

ICICI Prudential US Bluechip Equity

AUM: 105.68 crore **Expense ratio:** 3.02%

This fund invests directly in the blue-chip stocks listed on the New York Stock Exchange and the Nasdaq. It is benchmarked against the S&P 500 Index. The fund usually has a portfolio of around 25-40 stocks and follows the growth at reasonable price (GARP) approach to investing.

The fund house has tied up with Morningstar Equity Research Services for research assistance. Morningstar publishes what is known as the wide-moat index, which consists of companies that have competitive advantages over rivals. ICICI's fund portfolio is derived significantly from that index. However, the fund house also has additional filters of its own. It only invests in stocks that have a market capitalisation of at least $4 billion. The fund managers also have the freedom to pick stocks from outside the wide-moat index. In over one year of existence, the fund has done quite well (see graph below).

Motilal Oswal MOSt Shares NASDAQ-100 ETF

AUM: 65.58 crore **Expense ratio:** 1%

This passively managed fund invests in Nasdaq-100 stocks. Currently, its returns are much higher than that of the index because of the rupee's depreciation. The Nasdaq index is heavy on technology, consumption, life sciences, pharma and biotech stocks. One advantage of this fund is that its expense ratio is the lowest at 1%. Hence, it starts each year with an advantage over the other US-focused funds available in India. The expense ratio becomes an important consideration while investing in a mature market like the US, where long-term returns are unlikely to be very high.

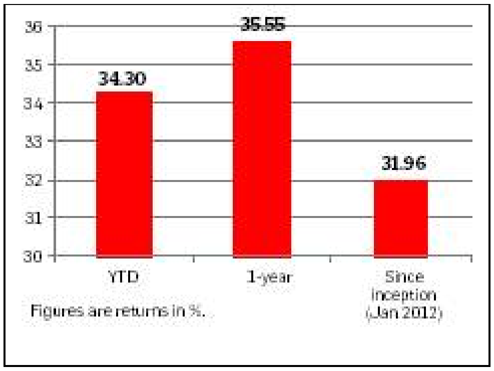
While it would have been better if we had a passive fund based on the S&P 500 Index, which is more widely representative of the US economy, this fund from Motilal Oswal is a good option for those venturing into the US market for the first time and looking for diversified exposure.

DSP BlackRock US Flexible Equity

AUM: 33.02 crore **Expense ratio:** 2.17%

This is a feeder fund that invests in Black-Rock Global Funds-US Flexible Equity Fund. The parent fund combines quantitative and fundamental research. By using both the approaches, it tries to achieve consistent performance while reducing portfolio risk. The fund invests in large-cap US companies. The term 'flexible' in the fund's name implies that the fund manager is free to invest in both growth and value stocks. The fund is benchmarked against the Russell 1000 Index. The Indian feeder fund's performance since inception (in graph) has been good. The mother fund's returns over the past one year, three years and five years are 22.87%, 12.38% and 3.30%, respectively. The benchmark figures for the same period are 26.23%, 18.04% and 8.49%, respectively. (Sources: Bloomberg.com and Russell.com as on 8 Aug).

The five US-focused funds don't yet have a track record in India, so investors should go by two criteria: expense ratio and long-term track record (of the mother fund, in case of feeder funds). By investing in the direct plans of these funds, you can reduce the expense ratio further. Finally, the rupee's sharp depreciation has boosted these funds' returns in recent times. This tailwind may not always be available.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YTD
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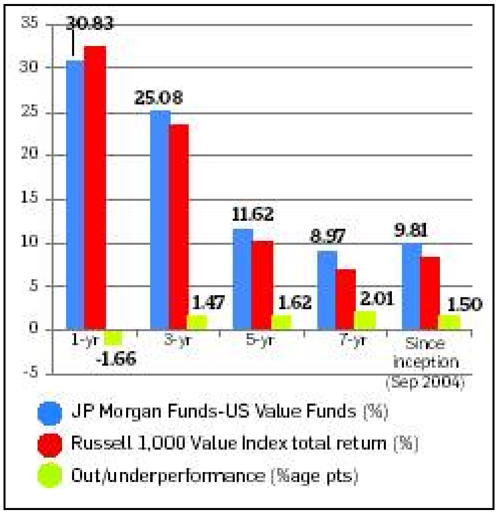
Since inception (Jan 2012)
Figures are returns in %.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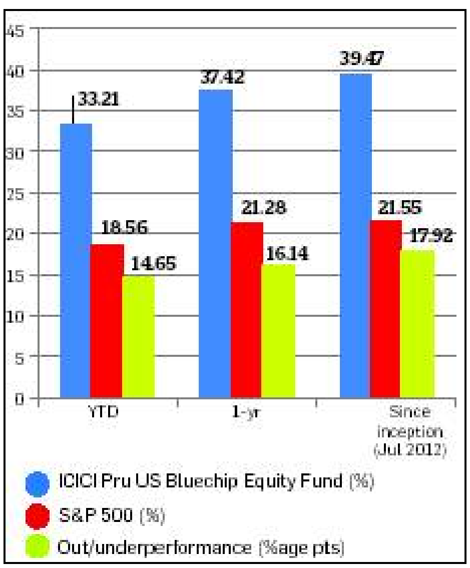
Since inception (Sep 2004)
JP Morgan Funds-US Value Funds (%)
Russell 1,000 Value Index total return (%)
Out/underperformance (%age pts)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YTD
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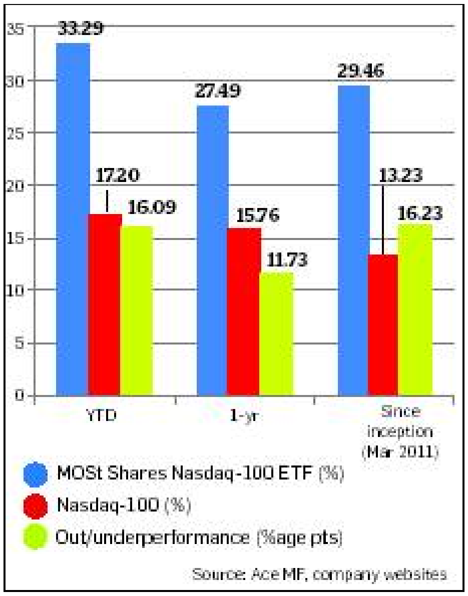
Since inception (Jul 2012)
ICICI Pru US Bluechip Equity Fund (%)
S&P 500 (%)
Out/underperformance (%age pts)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YTD
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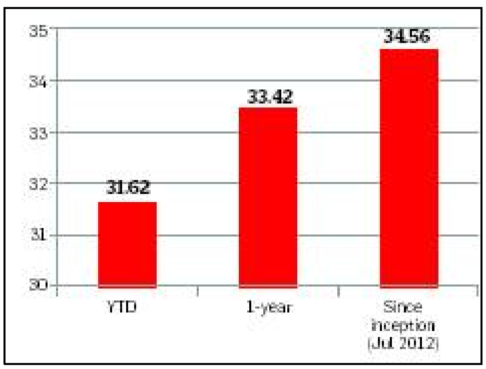
Since inception (Mar 2011)
MOSt Shares Nasdaq-100 ETF (%)
Nasdaq-100 (%)
Out/underperformance (%age pts)
Source: Ace MF, company websites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Since inception (Jul 2012)