MIRAE ASSET
Mutual Fund

Global Investing through ETFs

Even though mutual funds investing in overseas securities have existed in India for more than 10 years, investor awareness about these funds has been low. However, there has been a lot of interest in global investing in the last one year or so. One of the main reasons for investor's interest in global investing was economic slowdown in India which was exacerbated by the outbreak of the COVID-19 pandemic in India. In this article, we will discuss why you should add global investments to your portfolio.

Additional sources for potential wealth generation

While investing in Indian equities has the potential to create wealth in the long term, you can create additional sources to create wealth by investing globally. The table below shows that, winners rotate across different geographies. You can see that relative performance of different markets has changed in different years. As the table shows, there will be years when our country may underperform relative to other markets (you can see that we underperformed MSCI World in 5 out of the last 10 years). By investing in global equities you can generate additional source of returns – i.e. get potentially good returns from overseas market, when our market underperforms.

2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
USA 21%	India 32%	USA 50%	India 28%	USA 6%	USA 14%	China 45%	USA 4%	USA 34%	China 33%
World 13%	China 27%	World 44%	USA 16%	World 4%	World 11%	Asia 34%	World 0%	World 31%	Asia 28%
Europe 6%	Asia 26%	Europe 42%	China 11%	Europe 2%	Asia 8%	India 30%	India 0%	Europe 27%	USA 24%
Asia -1%	Europe 23%	China 17%	World 8%	India 0%	China 4%	Europe 19%	Asia -6%	China 26%	World 19%
China -3%	World 20%	Asia 17%	Asia 8%	China -3%	Europe 3%	World 16%	Europe -6%	Asia 21%	India 11%
India -20%	USA 19%	India 15%	Europe -4%	Asia -5%	India -1%	USA 15%	China -11%	India 8%	Europe 9%

Source: Bloomberg, based on MSCI country Indices (Large cap + Midcap); Asia excludes Japan, all the return are computed in INR based on FBIL INR/USD value. Disclaimer: Past performance may or may not be sustained in the future.

Benefits of diversification

Many investors ignore country risk when investing in domestic equities, but if you are investing only in your home country, then you are exposed to single country risk i.e. underperformance of your home country. The table above shows that, there is low correlation of returns among different markets; in other words, the performance of one market may or may not be dependent on performance of another market. Let us understand this by comparing India's returns with the US in the table above (we can compare multiple markets but we restrict ourselves to just two for the sake of simplicity).

We outperformed US in three out of last 10 years; the US outperformed in the other 7 years. In 5 out of 7 years, when US outperformed us (2011, 2013, 2016, 2019 and 2020) the outperformance margin was big; more than 10% in constant currency terms. In 3 years when we outperformed the US (2012, 2014 and 2017), the outperformance margin was big; again more than 10% in constant currency terms. In the other two years, the performance gap was small – 4 to 6%. This shows that there is low or even negative correlation of returns between the two geographies i.e. Indian equities and US equities. Low or negative correlation between geographies is an excellent reason to diversify across them. Investing in global equities can diversify risk considerably and bring stability to your portfolio.

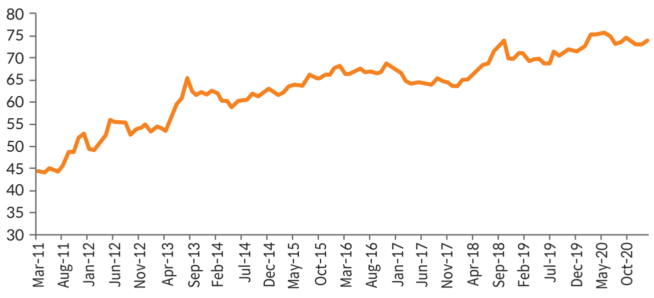
Exposure to themes not present in India

Global diversification can also give you exposure to global mega-trends which are at this point of time, not yet available in the Indian stock market. These mega trends have global reach and influence which Indian companies still have to develop. Think of companies like Apple - many of us use their products on a daily / hourly basis in our professional and personal lives. Consumer internet companies like Alphabet (Google), Facebook etc and e-commerce firms like Amazon are also part of our day to day lives. Most of these stocks have given very high returns in the last 10 years in dollar terms; in INR terms, these would have been huge wealth creators.

Apart from these mega-trends, you can get exposure to the global brands with global investing. Think of brands like Adidas, Nestle, Visa, Mastercard etc. Along with popularity in the developed markets, they are also very popular in India. With increasing globalization and millennials joining the workforce in India and elsewhere, these global brands are likely to grow in strength and in terms of popularity. Indian companies still do not have the kind of scale, global customer base, network effect and competitive advantage which companies of global stature have. Global diversification can also provide you exposure to new emerging themes like electric vehicle which are still nascent or not present in India.

Benefit from INR depreciation

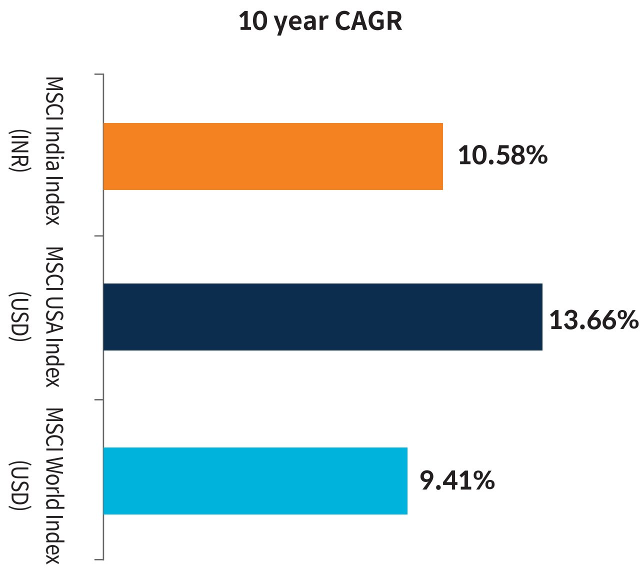
The exchange rate movement of the INR is also a good reason to diversify into global equities. Over the past several years INR has been declining and may continue to decline v/s USD . The chart below shows the INR / USD price over the last 10 years. INR depreciated at CAGR of 5.2% versus the dollar over the last 10 years. Therefore, over the past 10 years, INR depreciation itself would have contributed 5.2% each year on a CAGR basis to returns in global equity. However we must state here that, currency impact should just be one consideration for investment in global equities. Risk of equity as an asset class is much more than currency risk.

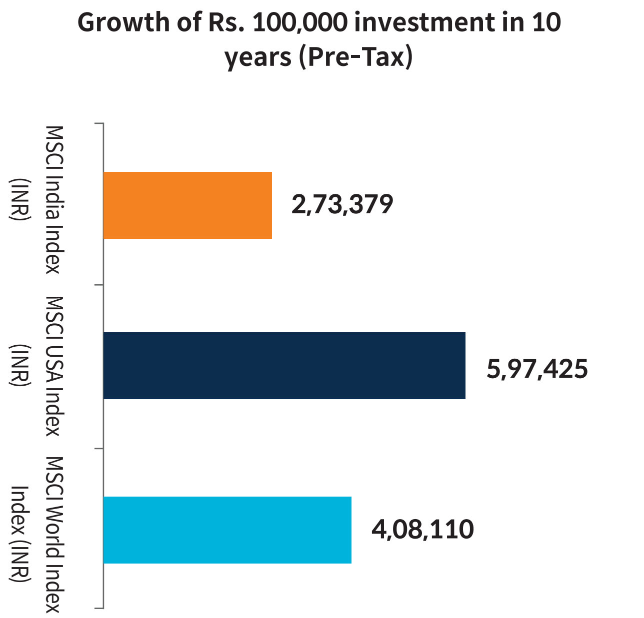


Source: Investing.com. Period: 01.03.2011 to 28.02.2021.
Disclaimer: Past performance may or may not be sustained in the future.

Global investing can create alphas on post tax basis

Unlike domestic equity funds, foreign funds are taxed as debt funds. Short term capital gains (investing holding period of less than 3 years) in debt funds are taxed as per the income tax rate of the investors. Long term capital gains are taxed at 20% after allowing for indexation benefits. However even on a post tax basis, foreign funds can create alphas for investors. You can see in the charts below that global investing (in MSCI World and MSCI USA) was able to outperform domestic investments in INR terms over the last 10 years – currency depreciation played an important role in the outperformance.





Source: MSCI, Investing.com, Advisorkhoj analysis. Period: 01.03.2011 to 26.03.2021.
Disclaimer: Above chart is purely for illustrative purposes and should not be construed as investment advice. Past performance may or may not be sustained in the future.

One of the major advantages of domestic equity funds is that they enjoy equity taxation. Foreign funds or fund of funds are taxed as debt funds. Continuing with the example above, let us see how the investments in the three indices would have fared on a post tax basis in the last 10 years. You can see that, despite debt taxation, global investments have the potential to create alphas. One of the benefits of debt taxation over long investment tenures is in indexation; indexation can reduce your tax liability substantially.

Asset Class	Investment	Indexed cost of acquisition	Final investment value	Long term capital gains after indexation	LTCG Tax Rate#	LTCG Tax	Post tax Investment value
MSCI World Index	1,00,000	1,80,240	4,08,110	2,27,870	20%	45,574	1,82,296
MSCI USA Index	1,00,000	1,80,240	5,97,425	4,17,185	20%	83,437	3,33,748
MSCI India Index	1,00,000	N/A	2,73,379	1,73,379	10%	7,338	1,66,041

Source: MSCI, Income Tax Department for CII data (indexation), Advisorkhoj analysis.
#LTCG of up to ₹1,00,000 in equity funds is tax exempt.
Disclaimer: Above analysis is purely for illustrative purposes. Past performance may or may not be sustained in the future.

Why ETFs are one of the better ways to take foreign exposure

- Global developed markets are more informationally efficient and hence it is difficult for active fund manager to outperform the market. The ETFs thus provide a simple and transparent route for investment in global market without the fund manager risk of underperformance.
- ETFs can provide focussed exposure to desired theme or segment of the market which active funds may or may not provide.
- Investing in foreign equities through ETFs is a globally popular approach among institutional investors.
- The biggest advantage of ETFs is low cost. Lower cost can make a substantial difference in returns over long investment tenures due to the power of compounding.

How does foreign product fit in investor portfolio?

Diversification plays most important role in balancing risk and returns, while improving the consistency of your portfolio performance across different market conditions. While domestic diversified schemes may form the core of your investment portfolio, adding foreign funds can provide the following benefits:-

- Geographical diversification along with exposure to themes which are not present in Indian stock markets
- Superior risk adjusted portfolio returns
- Potential to provide returns from local currency depreciation which may also act as a hedge against rising foreign expenditure
- Additional source of potential wealth creation over long investment horizon

The percentage allocation to foreign funds depends on your risk appetite and investment needs. You should consult with your financial advisor how global diversification through foreign funds can improve your overall portfolio risk and return profile.