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Cover Story guest column

Look Before You Jump

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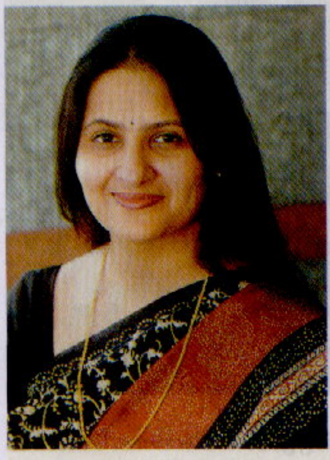

CONSUMERS ARE FEELING THE HEAT OF oil price rise and several economies are suffering from oil price-induced volatility in their stockmarkets. No doubt, then, that oil prices and inflation are eating away at the returns from your portfolio, too. It is hard to imagine that somewhere some economies and some investors are benefiting from these very developments. The oil companies are making 'windfall' profits and investors in these companies are benefiting. Are you one of them?

Chances are that your portfolio of investments shows a 'home-country bias', which means that you are invested almost entirely in Indian securities. And it is not surprising at all. In India, it was only until recently that changes in regulation have allowed us to geographically diversify our portfolios. But what is interesting is that even in developed markets where there have been few or no restrictions, investors feel a greater sense of reassurance with their home market because of the familiarity with it. Moreover, they believe they understand home markets better than overseas ones as access to information is easier, and that this advantage can help generate their desired returns.

But if the home-country bias is a result of risk-aversion, then it is important to point out that there is an element of risk inherent in investing, and diversification — particularly across geographies — serves to reduce risk.

Diversifying across a large number of securities reduces specific risk from firm-specific issues. But systemic risk remains, especially in a single-country portfolio that can be impacted by macro issues specific to that one market. However, this impact could be reduced through diversifying the portfolio geographically. With the exception of the US, Japan and the UK — at 49 per cent, 12 per cent and 11 per cent, respectively — no single country makes up more than 5 per cent of the total world stockmarket.

Indians should do their homework before investing in overseas markets

Another fact often missed is that some markets have a bias towards some industries. Indian stockmarkets, for instance, are weighted towards information technology, financial services and the energy sector, and are light on the consumer and healthcare sectors.

To overcome certain embedded biases in sector make-up at the country level, expanding the investment universe to a global level presents the opportunity to access industries that may be under-developed, uncompetitive or even non-existent in an investor's own domestic market.

So, the strongest and most compelling reason for building a global portfolio remains diversification. International investing lends itself perfectly to diversification benefits because each country's economy offers distinct inherent strengths and each has its own set of differing growth characteristics. Different markets and their sectors move to different factors and business cycles. Geographical diversification presents the potential of reducing risk and bringing more consistent returns.

One of the risks often talked about is the currency risk. While exchange rate fluctuations can have an impact on the returns from a portfolio, the long-term trend shows depreciation in the value of the rupee against major currencies benefiting foreign currency denominated assets. But, whichever way the currency exposure goes, barring major shocks, it shouldn't be a deterrent to international investing.

To sum it up, the fact that India accounts for only half a per cent of the world's market capitalisation only bolsters the case for global investing. And, in spite of an increasing integration of global markets, the correlation between India and other markets, developed or emerging, remains low — between 0.3 and 0.5. So, even a basic level of geographical diversification would bring a measure of stability to your portfolio.

It is, however, one thing to have access to a broad spectrum of investments and quite another to know how to piece them together to create an appropriate investment portfolio. While Indian investors can invest overseas, the daunting task of researching remains.

As with domestic investing, mutual funds provide the solution to this. Currently, investors are able to invest through feeder funds that invest directly in foreign equities. But once guidelines are notified, investors can also look forward to the opportunity to choose from a range of over a thousand funds that a global fund house such as Fidelity can offer, and benefit from the track record and scale of these funds.

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