China and India are expected to become major economic powers in the coming decades. **Alastair O'Dell** considers whether this prediction makes them good investment targets for UK pension schemes

Eastern promise, western pensions

The potential for growth in India and China is vast. Between them they represent a third of the world's population: the smaller of the two, India, has a population greater than the EU, US, Japan and Russia combined. If adept economic management manages to harness this resource, both countries will surely arrive at the world's top economic table.

Potential is one thing, realising it another. Despite the size of its population, India's economy is scarcely a third of the size of the UK's and if the factors that have hindered growth there in the past continue, its potential may never be fulfilled. A similar story applies to China, although it has certainly progressed further than India. As the country arrived on the world stage amid the fanfare of the Olympics, its economy quietly became larger than the UK's.

Global investors have shown interest in India and China since the publication of Goldman Sachs' BRICs (Brazil, Russia, India and China) report in 2001. The report focused on the prospect that these four countries will be among the world's largest economies by 2050 – and China and India are expected to top that list.

Both countries are still on track to achieve that: China achieved a phenomenal 9 per cent average growth rate between 1995 and 2005, while India grew at a respectable 6.3 per cent.

INDIAN SUMMER

Past growth rates are not necessarily a reliable guide to the future, but one person who thinks growth will accelerate is Paul Parambi, head of international business for Kotak, an Indian investment bank. He says: "The difference is that India opened up to trade in 1991. China opened up and started developing 13 years before India. To think where India could be, look at how China has developed over the last seven to ten years. India's time is coming. It's a market just coming into its own."

It took the Indian economy 50 years, to 1991, to double in size.

However, if per capita incomes grow at 7.5 per cent, as Parambi expects, incomes will double every seven to eight years.

"If you are a pension fund investor who is looking for investments that can generate returns over the long term, and in scale, then India is a market you need to look at," says Parambi.

David DaSilva, head of global emerging market strategy, at Nomura says: "Investing is about prospects and the future – where you think investment growth will come from."

The current size of these economies is not represented by the size of their stock markets. MSCI Barra has created a global index based on shares available to international investors. According to this, China accounts for only 1.6 per cent and India 0.8 per cent of the world's market capitalisation (total value of all shares). Even from the group of 25 emerging markets recognised by MSCI Barra, China only accounts for 15 per cent of the index and India 7.3 per cent. Says DaSilva: "We think that China and India are undercapitalised and we will see their percentages on the index vastly increase."

LITTLE TROUBLE IN BIG CHINA

Chinese growth could be as much as 8 per cent while the US and UK struggle to achieve positive growth. Says DaSilva: "It will not all filter into the share prices but we see it as a major catalyst. It is easier to have earnings per share increasing in a growing economy than it is in a stagnant one."

Purchasing power parity (PPP) allows comparison on the basis of what consumers can actually buy, rather than of the exchange rate. The International Monetary Fund found that the contribution to 2007 world GDP (Gross Domestic Product – the total value of goods and services produced in the course of a year) on a PPP basis was 4.6 per cent for India and ➔

➔ 10.9 per cent for China. The largest economy, the US, contributed 21.4 per cent (shared between vastly fewer people). Says DaSilva: "It is interesting to see China's output on a PPP basis is half that of US. On a market capitalisation basis US companies represent 44 per cent and China's 1.6 per cent. Over the long term you would expect reasonable similarity between market capitalisation and participation in global GDP."

Some industries, such as telecoms, have performed exceptionally well in both India and China. In the first quarter of 2008 China Mobile signed up 21 million new subscribers.

"This is equivalent to a third of the UK population getting a phone in three months," says DaSilva. "It represents the consumer demand filtering through. Just think what else is going on: how many are buying cars? Or toasters?"

ROCKY ROAD TO FORTUNE

UK pension schemes also need to be concerned about volatility and, in this regard, both India and China are also still firmly in the emerging market camp. Says Parambi: "The volatility of the market compared to western ones can surprise at times – you need to be prepared for it."

For example, the Hong Kong stock market, the Hang Seng, has declined by more than a third since its highest point in November 2007.

However, developed markets are hardly immune to 'irrational exuberance' and subsequent crashes.

Another key attribute is whether investing in India or China will help to diversify a portfolio: there is no point holding assets that behave in the same way. In the short term there is likely to be significant correlation between emerging and western markets, as Parambi says: "If global markets are going down then it is unlikely that Indian markets are going to go up."

In the longer term there are strong reasons to think that decoupling – moving independently – will occur. For example, because India imports around two thirds of its oil it suffers when global demand is strong and benefits when demand is weak. As it is not a major exporter of finished goods, so it is not affected by western demand for products.

"We are now seeing a significant reversal of oil and commodity prices," says Parambi. "So we could see India outperforming western markets and, to a certain extent, becoming less correlated."

China is more correlated with the west as it both imports and exports in similarly huge levels of goods but in the future its own domestic demand will make it less dependent on trade. China is complicated by shares being divided into those open to domestic investors (A Shares), shares that foreign investors can invest in on the mainland (B Shares) and Hong Kong (H Shares).

UK pension schemes can invest directly in India, but this is complicated by the notoriously bureaucratic Indian state. Kotak, as well as several competitors, offer offshore funds. Many will prefer the ease of investing this way, as Parambi says: "Offshore funds are a convenient and very easy way of investing in India."

LANDS OF THE RISING SUMS

Some practitioners advocate using a country's share of global capitalisation as a benchmark for how much to hold in a global portfolio. Says DaSilva, "The MSCI global index is a reasonable proxy to look at. I would probably be matching its 11 per cent in emerging markets."

DaSilva's recommended weighting is far from the industry standard. Nomura's research has found that well under 5 per cent is allocated to emerging markets in global equity portfolios.

This may partly be due to the speed at which the markets are evolving. In the last 18 months the MSCI emerging market index has increased by almost 19 per cent.

Another anomaly is how schemes invest in emerging markets. Many larger DB schemes have a dedicated Japan manager, but very few offer the same for emerging markets despite the sectors' similar size. "There is much stronger case for having a manager in volatile emerging markets," says DaSilva.

Just because China's general economy is strong it does not translate immediately to an opportunity in the stock market.

"It is easy to paint a simplified picture that a strong economy equals a strong stock market – but it is more intricate and complicated than that," says DaSilva.

However attractive investing in high yielding emerging markets may be it should never be forgotten that they are highly volatile, less predictable and may never fulfil their potential.

"The number of people in India and China living on less than US$1 per day is huge," says DaSilva. "It is a lot better than ten years ago, but it is still nowhere near developed market status." ■

KEY POINTS

- **China and India are expected to be the biggest economies by 2050**
- **India is behind China because it opened to trade later**
- **If the value of their stock markets reflected their contribution to global GDP their value would shoot up**
- **India and China still have mass poverty and volatile markets but can provide huge investment returns.**