Business Standard

You can mitigate domestic risks by investing abroad, here's how

Open a low-cost international broking account and invest in low-cost international exchange-traded funds

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Representative Image

Over the past few months, the foreign exchange market has joined the Indian bond market in implying that despite the Monetary Policy Committee's efforts, India will not meet its commitment of limiting consumer price index (CPI) inflation to 4 per cent till March 2021. But even if India were to have high inflation of 5-7 per cent over the long term, the domestic equity component of one's portfolio is likely to partially mitigate this over the long term, that is, over many decades. However, neither domestic equity nor domestic real estate can be relied upon to mitigate several country-specific tail risks.

Noted financial theorist William J Bernstein categorised such deep risks as inflation, confiscation, devastation and deflation. Inflation includes very high inflation or hyperinflation, as seen in Argentina and Brazil around 1989. Confiscation could be overt or covert. Overt confiscation becomes more likely as a country becomes less democratic, while covert confiscation includes very high tax rates. Devastation is primarily caused by war, including a major terrorist attack. And finally, there is deflation, the rarest category of risk, as witnessed in Japan in 1989 and Greece in 2013. Such tail risks are too rare to attach probabilities to, but they are nevertheless relevant.

Diversify to reduce risks: International investments, including equities, offer better, though not complete, mitigation against some of these country-specific tail risks. The primary reason one should invest in international equities is to diversify one's risk by not putting 100 per cent of one's net worth in one country, India, which contributes just 3.3 per cent of world nominal GDP. None of us would be willing to put 100 per cent of our net worth in Italy, which is an economy of a comparable size. This is despite Italy's S&P sovereign credit rating being one notch higher than India's. India's credit rating incidentally is one notch above junk.

The second reason is that though India's equity returns are highly correlated to world equity returns over the short term (years), over the long term (decades) that correlation is likely to be much lower. India's total (that is, including dividends) and real (that is, net of inflation) equity returns over several decades provide an illustration. Since reliable long-term total real returns data for India does not exist, the following is a rough estimate. Over the past 33 years, since the launch of the Sensex, India's returns have been close to US returns. But if one looks at the past 80 years, then India's returns have been drastically lower than US returns (this is based on data from 'Global Stock Markets in the Twentieth Century' in The Journal of Finance in June 2002 by Philippe Jorion).

The ideal option: Since India's mutual fund industry is still maturing, ideal options don't exist. However, a hypothetical ideal option provides a baseline to compare the actual options against. The hypothetical ideal option is an Indian low-cost (expense ratio about 5-10 basis points a year) feeder fund that invests in the Vanguard US S&P 500 ETF (whose expense ratio is 4 basis points a year), or the equivalent index fund.

The only bearable option then is the Vanguard US S&P 500 ETF through a foreign broking account. To avail of this, one needs to first open a low-cost foreign broking account directly from India. Such a broking account's cost (minimum guaranteed revenue for the broker) of $10 per month subjectively makes it ideal for someone who expects to have a cumulative investment of at least Rs 5 million through this route, over the next five years. The second step is to transfer funds from India into the broking account in the US under India's Liberalised Remittance Scheme (LRS). The final step is to stagger the purchase of the Vanguard US S&P 500 ETF over several years.

This route has three important tax-related disadvantages. One, your Indian income tax returns will become more complicated because you will be forced to separately disclose all foreign assets and income. Two, India's ambiguous tax laws force one to assume that US ETFs will be taxed like US equity shares. Accordingly, if one holds such US ETFs for more than 24 months, then after indexation benefit one will have to pay capital gains tax at a rate of around 20 per cent. Three, while this route currently does not objectively increase the risk of a tax scrutiny, these rules could change in the future. Such a tax scrutiny would distract the investor from his job or business. Hence, an investor thinking of taking this route should consult a chartered accountant about all these three taxation-related aspects.

High cost of Indian feeder funds: If you use one of the feeder funds available in India that invest in US equities, you will enjoy a few advantages. Your tax filing will not become more complex. You will also enjoy clarity that your investment in this fund will be taxed like a debt mutual fund. It will also eliminate any possible future risk of tax scrutiny. But the combined cost of the largest such feeder fund through a direct plan together with the underlying actively managed fund is around 186 basis points per annum (as of September 18, 2018). To achieve any diversification, the investor will have to put in at least one-fourth of his net worth in international equities. However, the high cost of such schemes makes them unsuitable for such a large proportion of one's net worth.

Compensate through asset allocation: But what if an investor is not willing to invest outside India, or is unable to because his net worth does not justify the cost? In that case, he cannot partially mitigate these tail risks. But he should still try to compensate for this through his asset allocation. For example, an individual who is not willing to invest outside India may have to limit himself to a lower equity allocation compared to an equivalent individual who is willing to invest outside India. Also, for such an individual, any exposure to Indian mid-caps or small-caps increases the risk further and is counterproductive.

Ideally, an investor should diversify outside his home country, which in our case is India. And if he does not, then he should try to compensate for this through his asset allocation.

Roadmap to international investing

- One option is to invest in the feeder funds available in India, but they are expensive
- Open a low-cost international broking account
- At a cost of around $10 dollar per month, you will get access to low-cost international ETFs
- A good option is the Vanguard US S&P 500 ETF, which has an expense ratio of just four basis points per annum
- Consult your chartered accountant when making such investments as your tax filing is likely to get more complicated

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