Investment Strategy

Foreign-returned

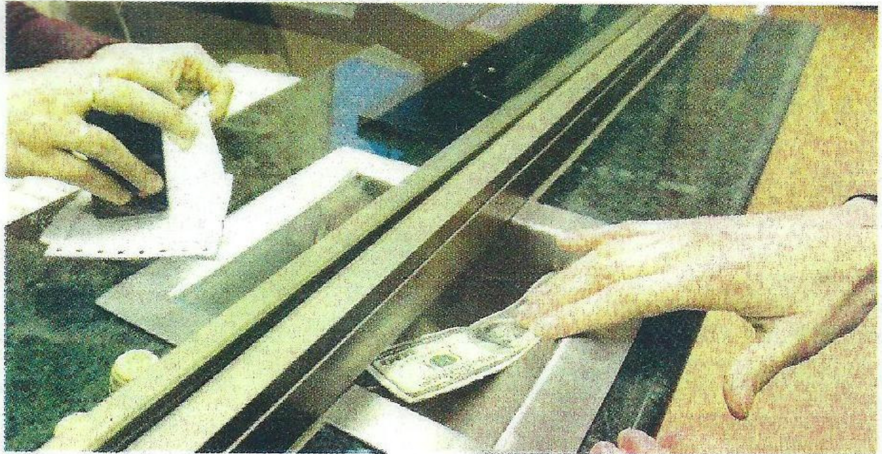
International funds with equity as underlying asset are also subject to foreign-exchange risk

The Indian stock market has underperformed its global peers like Japan's Nikkei by 0.4%, the US's Dow Jones Industrial Average by 11.4% and the UK's FTSE 100 by 4.3% in 2012 till 27 June 2012. Economic growth has dropped below 6% per annum in the last quarter of the fiscal ended March 2012. The Index of Industrial Production growth was flat in March, April and May 2012. The weakness in the rupee to the 56 a US dollar level has added to the woes of investors in India. Inflation, too, is in no mood to cool as it is still hovering in the range of 7.55% per annum. Looks like India will be witnessing a phase of stagflation, where low growth is accompanied by high inflation in the coming few months.

All this has taken a toll on investor sentiment. As the end of the tunnel is nowhere in sight, investors are looking at different options to invest. Debt has emerged as a favorite asset class for both the high networth investors and retail investors. A large amount of money is being parked in fixed deposits of banks and companies and fixed maturity plans of mutual funds.

The potential return from these instruments is limited and at times may not be enough to beat inflation. In such a scenario, investors are looking at investment opportunities to give them double-digit return. In such a scenario, asset management companies are promoting their international funds aggressively. Recently, ICICI Prudential Mutual Fund closed its new fund offer focused on the US markets. The fund tried to cash in on the falling rupee and the deteriorating confidence of investors in the domestic market.

Though international funds may aid in diversification of portfolio, they carry risks that are different from India-oriented funds even if the underlying asset class is the same, i.e., equities. These funds are only for investors who already have a well diversified portfolio and can afford to take additional risk to get more returns.



Not tax efficient

An international fund with equity as an underlying asset class carries all the risks associated with equities but also is subject to foreign exchange volatility. Thus, if an investor manages to get capital appreciation of 15% from the fund in dollar terms and the rupee becomes stronger by 5% in the same period, then the effective return will be only 10%, i.e., 15% gain from the fund less the forex loss of 5%. If the investor has to negate the forex risk involved, he may have to hedge his position by booking a forward contract for the period he proposes to invest in the fund. This exercise will dilute the return from the fund to the extent of the commission the bank may charge for the forward contract. Also, taking a forward contract is only possible if the investment amount is sizable as no bank will entertain a forward contract for small amounts.

Second, tracking international markets to make an entry and exit call is not an easy task. Investors will also have to keep a tab on the foreign exchange movements.

Third, any international equity fund is not as tax-efficient as an Indian equity fund. Income from international funds is subjected to the same treatment as taxed like debt funds. Long-term capital gain will be taxed at 10% without indexation or 20% with indexation. Any short-term capital gain will be added to the investors' income and taxed at the rates applicable in that particular year. Though tax-free, dividends in the hands of investors are subject to a dividend distribution tax of 12.5% plus applicable surcharge.

Moving to the currency beat

Most international funds would have underperformed the market if appreciation of the US$ is ignored

NAME OF THE FUND	1-YEAR RETURN (%)	1-YEAR DOLLAR APPRECIATION (%)	EFFECTIVE RETURN (%)
DSP Blackrock World Gold Fund	2.28	27.10	-24.82
Fidelity Global Real Assets Fund	10.45	27.10	-16.65
Franklin India Asian Equity Fund	6.14	27.10	-20.96
DWS Global Agribusiness Fund	13.70	27.10	-13.40
HSBC Emerging Markets Fund	-4.05	27.10	-31.15
Principal Global Opportunities Fund	7.70	27.10	-19.40
ING Latin America Equity Fund	-7.95	27.10	-35.05
MOST Shares Nasdaq- 100 ETF	42.18	27.10	15.08
ING Global Real Estate Fund	20.61	27.10	-6.49
BSE Sensex	**-8.20**	**NA**	**-8.20**

List not exhaustive. Return as on 26 June 2012

Investing in international funds may make sense if an opportunity in international markets is not available in India. For instance, investing in gold mines may not be possible in India as major companies in the sector are listed outside India.

Before investing in international funds, investors should do their home work. For instance, if a fund proposes to invest in a country expected to grow at 4% per annum in the coming two years, it may not be prudent to invest in such a fund. Even after taking a very conservative estimate, India is likely to grow at a pace of more than 5% in the coming year or two. Thus, does it makes sense to go international is the question investors should ask before taking the leap.

— Rahul Mantri