Connecting the Dots

What no one told you about passive investing

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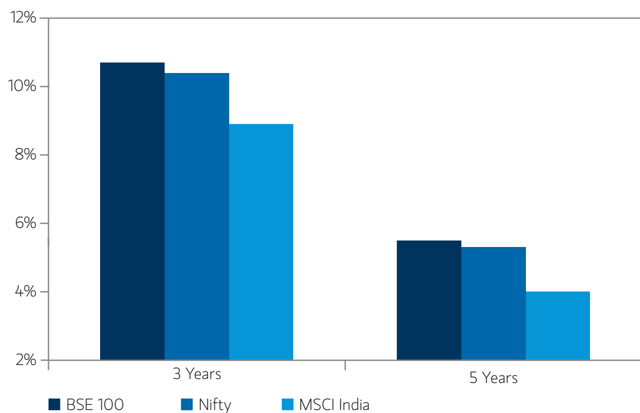
The lure of predicting short-term price movements is hard to resist for market participants. Whether or not it benefits investment outcomes is highly debatable, but it is a very enjoyable pastime nonetheless. With the rise of passive investing over the last few decades, albeit to a smaller degree in India, a recent addition to this has been the game of predicting which stocks will get included in the benchmark indices at their periodic reviews. To the uninitiated, passive investing is an approach that seeks to match, not beat, the return of a particular stock index by attempting to totally or substantially mimic the index. While Indian investors may be focussed on the Nifty or Sensex, foreign investors typically benchmark to indices created and maintained by MSCI or FTSE (Financial Times Stock Exchange).

The game is that, if one is able to guess the inclusion probables and buy those names before passive money is forced to buy these same issuers, one stands to make a handsome short-term profit. Just before the announcement date, frenetic activity starts in trying to predict such inclusions. The time gap between the announcement and the inclusion date is typically two to three weeks and that is the period over which one is trying to make a quick buck. This has absolutely nothing to do with the fundamentals of the stock, but it does ramp up the share price of inclusion probables ahead of the index inclusion date. Research by Morgan Stanley, which analysed 50 instances of MSCI inclusions from 2010, shows that in the month leading up to the inclusion, the median outperformance over MSCI Index was 5 percent. On the other hand, in the one month after the inclusion, the same stocks underperformed the index by 3 percent.[1] Simply put, this means if one invested in an MSCI tracking exchange traded fund (ETF) and advertised the amount and date on which they were going to buy a certain stock, they ensured that they bought it pretty much at the peak of its relative performance. Put charitably, this is momentum investing. Put plainly, this is dumb investing, in our view.

[1] Source: RIMES, MSCI, Morgan Stanley Research. Data as of November 2015.

There are facets of how the composition for MSCI indices is determined that are puzzling. Like most indices, MSCI uses the free-float market capitalization to decide weights of stocks in its indices. This implies that market capitalization, excluding the share of the founders or promoter, will be considered since that is what is available for other investors to trade in. However, unlike domestic indices, MSCI also uses a special adjustment called Foreign Inclusion Factor (FIF) and foreign room. What this means is that it will consider the headroom available for new foreign investors to invest in the stock. Before we get into why that is a big deal, we will discuss what this adjustment cost the MSCI ETF investors. Versus the BSE 100, MSCI India has underperformed by 1.5 percent annualized over the last five years and by 1.3 percent versus Nifty. This is significant as Nifty's return over that period was 5.3 percent while MSCI India's return was only 4 percent *(Display 1)*. Mind you, both these are indices with a similar composition philosophy, except for the FIF adjustment, and we are not even getting into an active versus passive investing debate here.

Display 1: **Local indices outperformed MSCI India** (in INR)

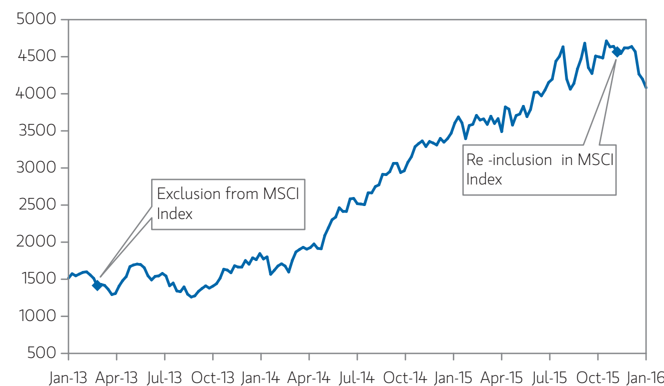


Source: RIMES, MSCI, Morgan Stanley Research. Data as of December 31, 2015.

It is easier to explain the concept of FIF with an example. Let's take the case of the fourth largest stock in India that has a market capitalization of USD 40 billion and, which despite this size, is not represented in the MSCI India Index.[2] As of the end December 2015, 47.4 percent of the stock's equity is owned by foreign portfolio investors (FPIs). The overall limit for foreigners to own a banking stock, as imposed by the Reserve Bank of India, is 74 percent. If you add this stock's holding of 26.5 percent to the FPI holding of 47.4 percent, foreigners cannot buy fresh stock from the market.[3] However, the stock is freely traded on the foreign window. For example, one foreign investor can buy from another in the market. Average daily traded value over the last six months on the foreign window is close to USD 14 million versus USD 23 million[4] on the local window. In the example stock's case, the value of FPI holding in the stock is almost USD 19 billion and that float is freely available to foreigners. As the FPI shareholding in Indian equities has kept going up, this has and will likely continue to create more headroom issues, especially in sectors with regulatory caps such as banking. It is the result of this process that the weight of banks in MSCI India is a meagre 3 percent with only two banks finding representation.[5]

Even more curious is the case of an automobile manufacturer in India *(Display 2)*. The stock was excluded from MSCI Index in February 2013 citing lack of foreign headroom. It subsequently increased its foreign ownership limit post when the stock got re-included in the index in November 2015. It's stock price was INR 1404 on the date of exclusion and INR 4556 on the date of re-inclusion. As an investor with money tracking the MSCI Index, one effectively sold at 1400 and bought it back more than three times higher within three years, a period in which the MSCI Index returned only 30 percent.

Display 2: **Price chart of an Automobile Manufacturer in India** (in INR)



Source: RIMES, MSCI, Morgan Stanley Research. Data as of January 25, 2016

On a country level, when compared to either the GDP of a country or its market capitalization, MSCI weightings in Emerging Markets (EM) indices are also skewed. We find it remarkable that for a lower total market cap than India, Korea's weight in the MSCI EM Index is over 80 percent higher.

[2,3] Source: BSE, Bloomberg, RBI. Data as of December 31, 2015.

[4,5] Source: Bloomberg. Data as of December 31, 2015.

For India to be fully represented in the index in line with the share of its EM market cap, India's weight should be over 10 percent versus 8.9 percent now *(Display 3)*.

Display 3: **Comparison of India and Korea in MSCI EM Index**

	GDP 2015e (USD bn)	Full Mcap (USD bn)	MSCI FF Mcap (USD bn)	Weight per MSCI FF Mcap	Weight per Full Mcap
India	2183	1493	274	8.9%	10.1%
Korea	1393	1212	499	16.2%	8.2%
Emerging Markets	25061	14763	3082		

Source: RIMES, Bloomberg, IMF, Morgan Stanley Research. Data as of January 22, 2016. FF Mcap - Free Float Market Capitalization

How MSCI decides to assign weights to stocks, sectors and countries is entirely their prerogative. As per last count, about USD 13 billion to USD 15 billion[6] was invested in Indian equities through MSCI benchmarked funds. Our simple submission to the owners of those USD 15 billion is that if one is investing money in a MSCI linked ETF, one should beware of the distortions it creates and let the lure of low fees not make them penny wise and pound foolish.

[6] Source: Bloomberg. Data as of January 25, 2016.

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The **CNX Nifty** is the National Stock Exchange of India's benchmark stock market index for Indian equity market.

The **S&P BSE SENSEX (S&P Bombay Stock Exchange Sensitive Index)** is a free-float market-weighted stock market index of 30 well-established and financially sound companies listed on Bombay Stock Exchange.

The **MSCI India Index** measures the performance of the Indian equity market.

The **MSCI Emerging Markets Index (MSCI EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

The **S&P BSE 100 index**, a rules-based, broad index, is designed to measure the performance of the top 100 large-cap companies in India that are listed at BSE Ltd. based on size and liquidity. The index is calculated in Indian Rupees.

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