India - A Nation on the Cusp

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For a developing market, India seems to have it all: Relative political stability, an educated, largely English-speaking population, and a relatively inexpensive labor pool to attract capital investment - especially in manufacturing and certain service-type industries. Yes, American readers think, "call centers," but there is much more to the Indian economy than those friendly voices on the phone.

The Indians have been highly successful in turning out hundreds of thousands of qualified scientists, engineers, chemists, physicians, and all the other core professionals that populate the STEM fields: science, technology, engineering and medicine.

Meanwhile, there has been a dramatic reduction in Indian poverty over the last few generations. The transformations of the Indian economy represent a massive improvement in economic prospects for millions of families - a historic feat exceeded in scale and scope only by China.

In some ways, China represents the Ghost of India Future: Both economies have made a tremendous transition from being largely centrally-planned, socialist economies to chiefly free-market economies, all within the living memory of people now in their prime earning years. Additionally, both countries have experienced mass-scale transformation from agrarianism to urbanization - freeing up huge numbers of workers for manufacturing and service jobs. And both countries have witnessed the rise of a meaningful middle class in the last generation.

The difference? China has a head start of about 12 years. China's economic liberalization came about in the late 1970s. India didn't get round to decentralization until 1991.

The Future of the Indian Middle Class

India bulls have a dream: What if the Indian middle class was able, within a reasonably short period of time, to catch up to the Chinese middle class? What would that mean for Indian domestic consumption - and by extension, for Indian families? What kind of growth would that entail?

To reach parity with China, we would expect things following to occur - and within a comparatively compressed time frame:

* The percentage of Indian households that own air conditioners would have to expand more than 20-fold - from just 2 percent of Indian households to 53 percent.

- Camera ownership would expand by a factor of four or five (from 5 percent to 23 percent).
- Color TV ownership would need to triple, from 34 percent of households to 97 percent.
- Ownership of personal computers would quintuple, from 6 percent of households to 31 percent.
- Ownership of refrigerators would expand from 18 percent of Indian households today to 61 percent. And so on.

With 192 million households in India, according to the most recent Indian census data, that's a lot of gadgetry. The appliance and gadget gap between India and China represents a massive potential for growth in a variety of domestic Indian industries, from retail to utilities to technology. Indeed, India's appliance and gadgetry penetration doesn't look too different from what China's looked like a decade ago. There's no reason why India cannot accomplish much the same result - and even eclipse China's success.

Meanwhile, as more and more Indians receive advanced educations in STEM fields, and as their management class gains experience in leading their enterprises, we should see more and more adoption of technology, both in the home and the workplace, as workers become increasingly familiar with technology products. The resulting rise in productivity represents another huge potential for earnings growth that is belied by their recent modest earnings levels and valuations.

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Perhaps best of all, though: Growth in India appears to be organic; It doesn't stem from the largesse of an expansive government, but from the grass roots of a dynamic and adventurous entrepreneurial class. Don't take the comparison with China too far, warns Adrian Lim, the senior investment manager on the Aberdeen Asian equities team. "China's growth is largely government-driven and there are many state-backed national champions," observes Lim. "India's economy, by contrast, is underpinned by its dynamic entrepreneurs."

Overall, while China has a lot to recommend it to investors, Lim prefers India in the long run, for its lower reliance on massive government stimulus projects and partnerships, greater economic freedom, greater accountability to shareholders and overall higher level of transparency.

Favorable Demographics

Demographics, they say, are destiny - and India's demographics favor continued economic expansion. Over the next two decades, India will add more than 25 percent of the total global pool of workers. Over the past 10 years, India has added more than 126 million workers to the labor force. It will add another 117 million workers between 2010 and 2020 - nearly five times China's total labor force growth. And between 2020 and 2030, India will add another 96 million - even as China's demographic bubble will begin to deflate: China will lose more than 54 million workers during that period of time.

Who benefits? Manufacturers and other labor-intensive industries. Exports. And anyone who markets and sells directly to Indian consumers. This is because every worker who enters India's work force works to boost the country's aggregate demand - one of the driving forces behind economic growth.

A Brief History of Indian Development

Although burdened by a chronic government debt problem, India had established itself as one of the world's fastest-growing economies. Even with the global recession that kicked in in 2008, India still grew by nearly 7 percent in 2008-2009. The Indian government upped deficit spending in an attempt to further stimulate economic growth in 2009-2010, with mixed results. Economic growth remained a solid 7.4 percent, dwarfing the growth rates posted in the west - but inflation kicked up, as well. India's current inflation number of 9 percent places it at or near the top of all the countries in the developed world.

Indian stocks took a hammering in 2011, as well - a 40 percent decline, which Lim ascribes largely to a broad tightening of monetary policy by Indian central banking authorities. Our view is that this is a positive development. Investors are able to buy into this compelling market at a relative discount.

Meanwhile, India is long overdue for a real move to arrest inflation. Although it's never fun to hit the brakes, Indian inflation is unsustainable at present, and is a very real burden on the economy. If the government can demonstrate its credibility and resolve in combatting inflation, Indian investors would not have to demand an inflation premium on their returns, and therefore asset prices would possibly be free to rise broadly, as a result.

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Investment Approach

The India Fund, Inc. (NYSE: IFN), managed by Aberdeen Asset Management Asia, has a decidedly more value-oriented bent to its portfolio, compared with the MSCI India benchmark. The investment approach seeks to maximize the benefit of the strong Indian commitment to transparency in its business culture, compared to elsewhere in the developing world.

The fund has a very "hands-on" approach to stock ownership. The managers own a concentrated portfolio of around 30 stocks - and their management team makes scores of in-person visits to companies in their portfolio and possible prospects for inclusion every year. The approach doesn't favor any single industry by design, but "we find good, well-run companies in growth industries such as IT, consumer and pharmaceuticals," explains Lim. "In the main they have learned to navigate the vicissitudes of policy-making. "

The emphasis on fundamentals and value, combined with the focused approach on the best ideas in the country allowed the fund to circumvent some of the landmines in the Indian market. In fact, the Funds' performance in 2011, though negative, was substantially better than the benchmark index.

Market Cap Considerations

You don't have to worry about The India Fund,Inc. acting like a closet index fund. Fund managers are willing to go well down market, into the mid-cap and small-cap arenas, to find value for fund shareholders.

Currently, about 18 percent of the Fund is allocated to mid-cap stocks, and 5 percent to small-caps. Another 1 percent of the fund is in micro-caps. The P/E ratio for the Fund is 12.29 as of this writing - a very solid value, given the level of economic growth, future growth potential and favorable demographic headwinds.

More specifically, India is currently an ideal venue for closed-end fund investing. Although the Indian economy is the ninth largest in the world, the supply of suitable stocks of companies large enough to absorb institutional investing is still not huge. Capital inflows and outflows into India - as with all emerging markets - can be volatile. This is not a problem for closed-end funds, though, as closed-end fund managers don't have to worry about hoarding cash to meet redemptions.

Moreover, in recent years, there has been a broad reduction of interest in emerging market funds in general. As a result, the discount to NAV for the India Fund has widened substantially. As of late February, 2012, the India Fund was trading at a discount of 11.22 percent to NAV. That's a huge fall from their average discount over the last three years of 4.08 percent.

Essentially, you are buying your portfolio at more than 10 percent off the actual market price. You may stand to gain a noticeable boost if the discount spread narrows back to historical levels. If discounts get too much worse than this, the Fund may well consider a share buy-back program. This would result in a sort of "floor" under the discount to NAV. But the potential upside is substantial.

The Bottom Line

Investing in India is going to have its ups and downs. Indian equities can be very sensitive to capital flows, which can be volatile. Furthermore, this particular fund does have a narrow and focused portfolio. This can increase short-term volatility as well, since only a few stocks can have a big impact on the performance of the Fund.

However, the continuing emergence of an Indian middle class, plus the immense, sustained demographic boom in the number of citizens entering their prime working years is a powerful story in itself. If you liked China several years ago - or if you're kicking yourself for not liking China even more back then - here's your second chance. ■