Opportunities and Challenges in Investing Abroad

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Abstract

Most of the investors in India have a huge home bias which means they prefer to invest in their home markets as against the foreign markets. Investors in US invest about 73% in their home market while the US stock market accounts for 50% of global equities. UK invests around 50% at home, while the UK stock market makes up only 10% of global stocks. Indians invest nearly 98-100% of their equity portfolios in the Indian Stock Market, which is only 2-3% of the global stock markets. In that sense, the home bias is more severe in the case of Indian Investors.

40% of the expenses of an Indian High Net worth Individual (HNI) are dollar-dependent. Given that the Indian rupee faces a 4-6% annual depreciation in the long run vis-a-vis the dollar, this is a perilous situation for Indian investors' purchasing power. The purpose of investing is to maintain and grow post-tax, post inflation purchasing power of the invested capital at an adequate rate. An exposure to only Indian equities is very risky because our expenses are linked to global currencies like dollar and corresponding exchange rates, but our investment corpus is linked only to domestic equities and currency which constitutes only 3-4% of the global economy.

Therefore an ideal investment portfolio would have exposure to global markets in proportion to the exposure of future liabilities in those currencies and on those markets. Hence this paper focuses on the benefits and opportunities which an Indian Investors has in investing in foreign markets. Also it familiarizes the investors about the associated risks in investing in foreign stocks.

Keywords: *Foreign stock, Investor, Exchange Rate, Currency risk*

Paper Type: *Theoretical*

Introduction

Advancement in technology has erased international boundaries. Now the whole world behaves like a single market. Distance has lost its meaning due to globalisation. In 2011, SEBI's move to allow the Indian investors to trade in almost 24 major global indices including that of US, Europe and Asia, sitting in their comfortable homes, strengthened the proposition that everything is local now. Most of the current and potential investors think of investing in well-known profit making companies like Google, Apple, Microsoft, Amazon etc., despite the fact that these companies are not listed in Indian Stock exchange. International investing offers a whole world of opportunities that is available at relatively low cost. For the smartest investors, it's a great deal. Indian investors can invest in them either directly or as a part of Mutual Funds/ Exchange Traded funds (ETFs).

Diversification is an essential investing principle nowadays. It protects a portfolio from being seriously affected by negative events isolated to only few stocks. Academic research has reached an overwhelming consensus that investors have better long term outcomes when they diversify widely among assets, classes, industries, company sizes and orientation between value stocks and growth stocks.

Investing in foreign companies can be lucrative but rewards come with additional risks and spotting worthwhile investments overseas can take a tad more work than finding them at home. Thus, one of the thorniest decisions investors have to make is whether to put the money into foreign stocks. The world of investments can be cold and hard. But if one does thorough research and keeps one head straight, then the chances of long-term success are good.

Objectives of the Study

The main objective of the study is to help the investors (current and potential) understand the opportunities available and associated risk involved in investing in foreign markets.

Research Methodology

For the purpose of the present study, mainly literature survey and secondary data has been used. The required secondary data was collected from the official website, various journals and research papers, diagnostic study reports and newspaper articles have been surveyed in making this study.

Review of Literature

A large number of studies have proven the impact of foreign inflows on economic growth of the countries. Different industrialists, experts and academicians have different views in personal investments made by individuals.

In a recent interview with Business Line, Neil Parikh, Chairman and CEO of the PPFAS Mutual fund admitted that "Today whether it is Accenture, IBM, Cognizant, TCS or Wipro, which are running in a similar business- If one likes the businesses but feels the valuations are high in India, then they should invest in markets abroad. With companies such as 3M and Nestle, the parent companies may be trading at lower valuations than the Indian arms, presenting an investment opportunity."

On the other hand, Dharmesh Kant, Head of Retail Research, Motilal Oswal, says that "Eventually, the growth opportunity of a company drives its stock valuation. Indian companies generally have higher growth visibility. Besides, companies such as Hindustan Unilever have high return on equity, which helps valuation". Hence it is prudent to buy stocks in individual countries. Investing in global holding companies could mean exposure to risks of many countries.

Vikas Gupta, Executive Vice-President - Traded Markets and Investment Research, Arthveda Fund Management Pvt. Ltd. in a newsletter dated 20th October, 2015 viewed that "Investing in foreign stock would reduce exposure to Indian Economy and hence exposure to global economy, hard currencies, developed markets central banks and capital markets will increase"

Quantum of Foreign Investment: Eligibility Norms

The Reserve Bank of India allows an individual to remit US $250,000 per financial year (April-March) under Liberalized Remittance Scheme (LRS) which can be used for investing abroad.

Another way of investing in foreign exchange is through the International Mutual Fund. These funds are denominated in local currency and there is no limit of investing in these funds as payment for such funds is made in local currency and hence no foreign exchange flows out of the country.

Process of Investing in Foreign Stocks

- Open a trading account with a brokerage house (ICICI Direct, Kotak Securities etc.) that offer overseas trading facility. Domestic brokers have tied up with international partners to allow this.
- Submit duly filled separate account opening form along with know-your-customer (KYC) documents.
- For investing/ trading in foreign stock markets, it is required to transfer money to the international partner of the domestic equity broker through whom the service is provided.
- Funds are transferred to the international partner as below:
  - ➢ Submit application-cum-declaration form under LRS,
  - ➢ Form A2 (this will be available with brokerage house),
  - ➢ Sign a form for Foreign Exchange Management Act (FEMA) declaration (this will be available with brokerage house),
  - ➢ Form authorizing the designated bank branch as authorized dealer (this will be available with brokerage house),

Once the funds are transferred, one can start buying and selling foreign stocks on the online platform.

Automatic Route and Approval Route

Under the Automatic Route, an individual does not require any prior approval from Reserve Bank of India for making overseas direct investments in Joint Venture or Wholly owned subsidiary abroad. Individual should approach an Authorized dealer Category-I bank with an application in Form ODI and the prescribed enclosures for affecting the remittances towards investments. However, in case of investment in the financial services sector, prior approval is required from the regulatory authority concerned both in India and abroad.

Benefits of Investing in Foreign Stocks

There are plenty of good reasons to invest abroad. Through investing abroad, even the individual investor can get international exposure and benefits stated below-

- **High Returns**
  International markets can offer many growth opportunities that may not be available in home countries. Exposure to these areas can boost return potential. Greater growth in emerging markets translates into the potential for greater returns.
- **Lower Risk**
  Investors can potentially reduce portfolio risk by diversifying their investments across different countries and various classes of assets.
- **Diversification of Currencies**
  An important benefit of international investment is exposure to currencies other than home currency. As currencies tend to move in different directions, when US dollar declining, investments in other international companies can help boost returns. This means that an investor who has stocks in different countries will experience less volatility over the entire portfolio.
- **Tax Reduction**
  Many countries offer tax incentives to foreign investors. The favourable tax rates in foreign countries are designed to promote a healthy investment environment that attracts outside wealth.

- **International Credit**
  Investors who have foreign investment portfolios have a broader credit base because they can access credit in foreign countries where they have significant investments. This is advantageous when credit sources available at home are expensive or unavailable due to various factors.
- **Benefits of Exchange Rates**
  International currency exchange rates keep changing. Sometimes the currency of the investor's home country may be strong and sometimes it may be weak. There are times when a stronger currency in the foreign country where an investor has a portfolio may benefit the investor.
- **Confidentiality**
  Many offshore jurisdictions offer the complimentary benefits of secrecy legislation. These countries have enacted laws establishing strict corporate and banking confidentiality. If this confidentiality is breached, there are serious consequences for the offending party.

International Opportunities

Investing internationally has often been the advice given to investors looking to increase the diversification and total return of their portfolio. International stocks represent added opportunities.

Many of these foreign companies operate in rapidly growing economies with extra-ordinary rates of return. Investing in foreign companies is a way to diversify. For example Home and foreign shares do not always move in sync. When one is up, the other may be down and vice versa. Markets are said to lack correlation. Foreign shares over the long term are sufficiently independent so that investing overseas can give smooth portfolio returns. A diversified portfolio balances uncorrelated assets to spread the risk.

From food companies to drug makers, many foreign stocks trade at big discounts to their Indian peers. The Kellogg company stock quotes at a Price Earnings of 23 times on the NYSE vis-à-vis the 42 times of Britannia Industries on the BSE. Same for pharma major Eli Lily, which is available at 28 times against 40 times for Sun Pharma.

Stock of several parent companies abroad also commands lower valuations than their Indian subsidiaries. The Nestle stock (26 times) is far cheaper than the Nestle India Stock (111 times). So is Unilever (25 times) vis-à-vis Hindustan Unilever (48 times). Hence it is a good idea to invest in foreign stocks that are available relatively cheap rather than investing in Indian stocks.

For most HNIs, at least a 10% exposure to global stock markets is possible at the initial stage. Since US market makes up 40-50% of global stocks, Indian investors should look at gaining exposure to it as an initial step. US portfolio provides an approximate return of 8-11% in the long run in dollar terms. With 4-6% rupee depreciation, that is a 12-17% rupee return. The next step after exposure to US market will be European and Japanese Stock markets. This will nearly complete the exposure to developed markets.

The advancement of technology and economic progress in many of the world's developing nations has spurred innovation, and thus provides a great opportunity for an investor to invest with such innovative companies around the world.

International Risk

Although the benefits of investing abroad are widely accepted theories, many investors are still hesitant to invest internationally. No matter how one chooses to invest, one need to be aware of the risks inherent in foreign securities. Investors need to appreciate the serious risk involved with international stocks.

- **Currency Risk**

  The major area of concern for retail investors is in currency volatility. For new investors, there is exchange rate risk. When investing directly in foreign market, one has to exchange their domestic currency into a foreign currency at the currency exchange rate in order to purchase the foreign stock. For e.g if one buys Japanese stock and the Japanese Yen rises against the home currency between the time one buys and sells the stock, the return will be worth more. On the other hand, if the Yen weakens, then investment returns also weakens.

- **Information Risk**

  It can be difficult for investors in foreign stocks to obtain detailed company information or to be confident that the information provided is accurate and complete. In many countries, financial disclosure practices and accounting standards are inferior making it difficult to take investment decision.

- **Business and Political Environment**

  Many countries suffer from political, social, and economic instability which makes investing in those places quiet risky. Foreign governments have different reporting and tax regulations on securities. Foreign companies are not required to provide the same detailed information as home companies provide. They may use different accounting procedures, which can make stock analysis difficult to understand.

  Unstable governments, abrupt changes in government policy, wars and geopolitical factors can also increase the risk aspect of foreign investments. It is also important to be aware of the market-cap size that a particular fund targets, as smaller firms can be even more susceptible to economic and political disturbances. Also, funds that invest in a specific region are typically riskier than those that are diversified across a wide range of countries, as any event in that region will have a much larger impact on a concentrated portfolio.

- **Transaction Cost**

  Although we live in a relatively globalized and connected world, transaction costs can still vary depending upon the market in which one is investing. Brokerage and commission are always higher in international markets compared to domestic rates. There are also other charges that are piled on top which include stamp duties, levies, taxes, clearing fees and exchange fees. In addition, if one is investing through a fund or professional manager, then there are higher fee structures. The process of obtaining knowledge about the foreign market involves spending a significant amount of time and money on research and analysis. These costs will often include hiring of analysts and accounting expertise for foreign financial statements.

- **Liquidity Risk**

  Liquidity risk is the risk of not being able to sell your stock quickly enough once a sell order is entered. There is no way for the average investor to protect themselves from liquidity risk. Therefore investors should pay particular attention to foreign investments that can become illiquid by the time they want to close their position.

- **Tax on Capital Gains**

  An investor holding domestic equities for over the year, there is no tax on capital gains. However there is no exemption on profits from foreign stocks .The investors will have to pay 20.60% tax on such gains.

Recommendation

- The Indian investor should buy a basket of not less than 20 global stocks in approximately equal proportion. These should ideally be from several different industries and sectors. It should be of high quality and should be available below their intrinsic value.
- In order to minimize transaction cost on buying foreign stock, one should trade through American Depository Receipts (ADRs). ADRs trade on local U.S exchanges and can be bought with the same transaction cost as other stocks listed on U.S exchanges. Although ADRs are denominated in U.S dollars, they are still exposed to fluctuations in exchange rates that can significantly affect its value.
- Currency risk can be mitigated through hedging the currency exposure. There are tools such as currency futures, options and forwards that can be used to hedge the risk. One of the easiest tool available to hedge this risk is the currency EFT which has good liquidity, accessibility and relative simplicity.
- In order to evaluate the liquidity of an asset before purchasing, one has to simply observe the bid-ask spread of the asset over time. Illiquid assets will have wider bid-ask spread relative to other assets. Narrow spread and high volume of assets results into higher liquidity and vice-versa.

Conclusion

The foreign market lacks direct correlation with Indian market hence investing abroad is an effective way to diversify the portfolio. It is a vital part of any well-balanced portfolio. There is an existence of too much growth opportunity overseas to take advantage of higher returns. By investing some portion of the total assets in foreign securities, one can take the benefit of worldwide growth in today's global economy without taking on excessive risk.

Foreign Investments are exposed to varied risk associated with exchange rates, political or economic instability, and differences in reporting and tax regulations. By understanding some of the main risks and barrier faced in international markets, an investor can position themselves to minimize these risks when investing abroad.

To understand these risks in relation to the potential rewards, investors have the opportunity to access foreign markets through various instruments such as ADRs, international stock traded on U.S exchanges and U.S multinationals. If the domestic currency is relatively stronger than foreign currency, then it will be advantageous for individuals to invest abroad. Through understanding the trends and behaviour of foreign capital flows, one can foster the growth opportunities. Thus it is rightly said,

“In Investing, what is comfortable is rarely profitable” - **Robert Arnott**

Know the boundaries of your comfort zone and practice stepping out of it in small doses.

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