DIAMOND HILL

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Investing in India & China: Separating Hype from Reality

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We recently had the opportunity to discuss emerging markets and some of the investing opportunities portfolio manager Krishna Mohanraj, CFA, is currently identifying in markets.

Krishna Mohanraj, CFA
Portfolio Manager

You've previously discussed a double discount investors can take advantage of in international markets. Can you define this double discount and discuss whether it's still around today?

Krishna Mohanraj, CFA: Big currency moves can lead to some highly unusual, highly attractive situations, and if you're focused on intrinsic value — as we are at Diamond Hill — you can take advantage of those moves. We saw this, for example, in 2022: Last year we bought a company called Exor Group. Exor had just sold an insurance company six months before and was set to receive more than half the company's market cap in cash — much of it in USD. Of course, with the outbreak of the Russia – Ukraine war in March, Exor's shares sold off along with other European industrials. But if you look carefully, as the dollar appreciated, and given Exor was set to receive US dollars, the company's intrinsic value (at least on a spot basis) increased quite a bit, and the market didn't seem to recognize that.

It's an example of how we can not only invest in a high-quality business at a discount, but also receive an additional discount — an additional margin of safety in the currency — as we were buying shares in euros. No matter what happened with the war, no matter what happened with the energy crisis in Europe, we could buy Exor more confidently.

That's what we mean by the double discount, and in international markets you can capitalize on it periodically. We are not currency traders — we don't believe we can add value by predicting currency moves — but because we are so focused on intrinsic value, every once in a while, currency gives us an additional discount and additional margin of safety. Those are exciting moments for us in international investing.

I think the fascinating thing today is there seems to be almost a complete lack of imagination in the way people invest. Almost everybody seems to be loading up on seven or eight US mega caps, accounting for most of the headlines and all followed by a multitude of analysts daily. That herd behavior happens in international markets, too, but it creates sometimes fabulous opportunities for us because you have an abundance of high-quality international companies that get a lot less interest than comparable companies in the US. And whether it's due to currency or something else, if you're selective and focus on intrinsic value, it becomes a great place to hunt for attractive investing opportunities.

Zeroing in on some specific geographies, you've visited India this year: Any thoughts on Indian markets from an investing standpoint?

Krishna Mohanraj, CFA: Let me start by saying we invest in companies, not countries — so we are always looking for good businesses around the world. Then, too, everyone has heard the India story. There are volumes of research on the demographic advantage, structural reforms the Modi government is undertaking, etc. — and all of that is big and important, but it is not what we are primarily thinking about when we visit India.

The most interesting thing about India to us is there are myriad listed companies. India represents a relative fraction of our benchmark — roughly 4% — but it has close to 6,000 listed companies. The mega- and large-cap companies in India currently look pretty similar to what we're seeing in the US: Those companies are pretty richly priced — trading at 50, 60, 70 times earnings — because the magnitude of the opportunity for some of these established companies is widely recognized by the market.

What we are trying to understand is whether there are companies likely to be big winners in that market that are not recognized today. Where is there a difference between reality and perception? Because it's clear when you look industry by industry, penetration of the formal sector is so low in India that there is going to be a significant opportunity. The question is who is going to win and who will be the world-class operators that are going to be great investments. Our objective is finding those companies and management teams and including them in our portfolio over time when the price is right.

You've also spent a lot of time analyzing the opportunities in China. There were high expectations at the start of 2023 that the country's economic reopening would be a big market driver — though many of those expectations have been disappointed since. What are your thoughts on the Chinese equity market right now, and what's your near-term outlook?

Krishna Mohanraj, CFA: I think some historic perspective is in order when discussing China, where we've been invested one way or another over the course of the strategy's history. If you look at the last decade, there's been a disconnect between reality and perception in nearly every country. With China, most analysts were significantly over-optimistic — so for the first five, six years of the past decade, it was quite challenging to invest in China because it was hard to find attractive opportunities.

Then, we went through a period where we found selective ideas — like Tencent, which had idiosyncratic issues tied to licensing new games, etc. Now, I feel the reality and perception have gone in completely the opposite direction — that is, reality may now be a little better than perception. As a result, we are cautiously optimistic in terms of our positioning. Though we're not narrowly focused on benchmarks, one way to think about it is we are still underweight China.

As with every country in which we might invest, we're very selective about what we want to own, and we are looking for high-quality businesses at deep discounts. But with China, we also ask whether, looking ahead, things are going to be anywhere near where they were over the past five years. Whether from a demographic, economic, regulatory or geopolitical perspective, it is hard to believe things could approach the sweet spot they were in over the last five years.

Consequently, it's hard for us to anticipate the same valuations we saw five years ago. We have to be mindful of the discount rates we are using in our models, and we have to be mindful of the extreme range of outcomes that could be possible in China. We are always thinking about these things when we're investing.

Looking forward, short of having a crystal ball, there's not a great way to guess what will happen in the remainder of 2023. Regardless, we will be watching with interest and will certainly be alert to any potential investing opportunities we may identify in the period ahead.

As of 31 July 2023, Diamond Hill owned shares of EXOR NV and Tencent Holdings Ltd.