



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

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India: Land of Investment Opportunity?

The playing field is being leveled.

Nandan Nilekani, CEO, Infosys

When we wrote about China's "March to Modernity" in last October's investment commentary, we received much good and useful feedback from clients and friends. This quarterly commentary takes a look at India – another emerging stock market of global significance. India, like China, has been growing its GDP at double the rate of the U.S. for the last decade, and we believe that it makes sense in the investment business, as well as in almost any other business, to know what is happening in India. It has the world's second largest population of 1.1 billion people, and at its current growth rate, India will surpass China in this category in the not too distant future. Perhaps more importantly, its rapidly expanding middle class totals more than 300 million, a number that exceeds the entire U.S. population.

India has a rich and varied history and culture of many thousands of years, and a commentary such as this must necessarily be limited to reviewing events of the recent past and focusing on the current state of India from a political and economic perspective. As with China, this commentary seeks to answer the question about whether or not it makes sense for investors to consider investing in the Indian stock market.

India Since Independence

On August 15, 1947, India gained its independence after more than 150 years of British domination of the Indian subcontinent. The partition of the subcontinent into the two independent nations of India and Pakistan was a tumultuous and often violent process. Fearing persecution and violence, more than 10 million people fled from their homes and moved to another region, but tragically, in this process, more than one million Hindus and Muslims were killed in rioting and communal violence. Today Hindus comprise 80% of the Indian population, yet India's Muslim population of 160 million people makes it the second largest Muslim state in the world (after Indonesia). A country of enormous diversity, there are fourteen official languages with Hindi the national language. English enjoys associate status and is used for national, political, educational and commercial communication. At the time of independence, India established a written Constitution which gives universal suffrage for all people 18 years of age or older. India is the largest nation in the world with a functioning democracy.

The history of the struggle for independence is inextricably linked to the India National Congress party and the lives of Mahatma Gandhi and Jawaharlal Nehru. Gandhi was the spiritual and charismatic leader of the Indian independence movement for more than 30 years, developing a political approach that included gradualism, non-violence and civil disobedience. Nehru, a barrister like Gandhi, came from a Brahmin family and was educated at Harrow and Cambridge University in England. Nehru was the more practical hands-on leader of the 15 million strong Congress party and became India's first Prime Minister

in 1947. He served in this capacity until his death in 1964. Several years later, his daughter Indira Gandhi became leader of the Congress party and India's Prime Minister. She served until 1984, when she was assassinated by several members of her Sikh bodyguard following the storming of the Golden Temple in Amritsar in Punjab, the holiest temple of the Sikh religion. The so-called Nehru-Gandhi dynasty continued

in 1984 when her son, Rajiv Gandhi, was elected Prime Minister and served until 1989 (he, too, was assassinated in 1991 by a Tamil suicide bomber). His widow, Italian-born Sonia Gandhi, became head of the Congress party in 1998 and saved it from possible extinction. Her popularity and leadership returned the Congress party to power in 2004 in a coalition government. When forming a government, Sonia Gandhi chose not to become Prime Minister but asked Manmohan Singh to assume that role. He continues in that role today.

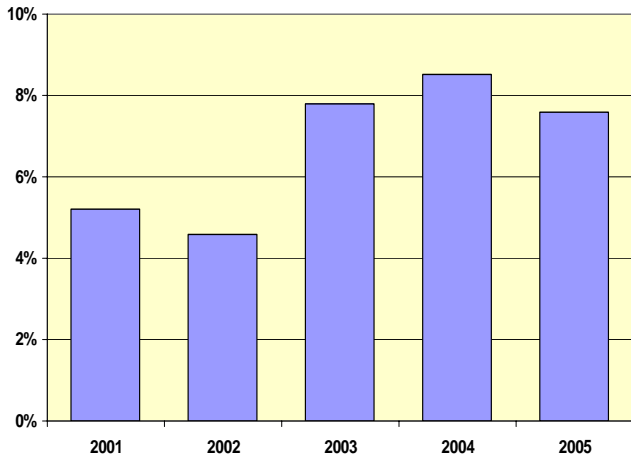
After gaining independence, Nehru opposed Gandhi's vision of an agrarian society and instead advanced a program for the industrialization and socialization of India. Influenced by Marxism, Nehru launched a series of 5-year economic plans which included the state ownership of much heavy industry, utilities, banking and media enterprises. Business was hampered by heavy bureaucracy, and taxes were high. Foreign direct investment was discouraged, which was consistent with Nehru's foreign policy of neutrality during the Cold War. On the other hand, laws were passed to abolish discrimination based on caste, and a major effort was made to ensure that every child would be enrolled in a primary school. One of Nehru's enduring legacies was the establishment of the famous Indian Institutes of Technology. These great universities planted the seeds for India's technological sophistication over the past several decades. Since Indian independence, there has been great tension with Pakistan – especially over Kashmir – which has resulted in war on several occasions. Relations with China have also not always been good, due to China's occupation of Tibet in 1950 and various border disputes. India fought China briefly in 1962, incurring defeats in several battles before peace was negotiated. For most of the period during the Nehru-Gandhi dynasty, India's economy grew at 4% or less, barely keeping ahead of its population growth so that per capita income grew only modestly.

Dramatic Economic Change Starting in 1991

In 1991, when Manmohan Singh became Finance Minister in Narasimha Rao's government, India's economy was in shambles. There was a huge balance of payment deficit, and there were no foreign lenders prepared to finance it. India had barely \$1 billion in foreign reserves – roughly equal to two weeks imports (today foreign exchange reserves are in excess of \$100 billion). The budget deficit was 8.5% of GDP, and the only way to finance it was for the central bank to monetize it, creating even higher inflation. Singh, an economist and later Governor of the Reserve Bank, turned this crisis into a moment of economic opportunity. He launched a series of ambitious, unprecedented economic reforms which have changed the face of India. Singh started the process of simplifying and rationalizing the tax system. Controls and regulation on industry were removed. Entrepreneurs no longer needed a permit for every minor change or initiative (what had been called the Permit Raj). Foreign direct investment was encouraged, and a climate conducive to business and economic growth was fostered. Presenting the Budget in Parliament in 1994, Singh quoted Victor Hugo: "No power on earth can stop an idea whose time has come." And the idea that India was on the road to rapid economic growth took root, becoming a significant force in the global economy.

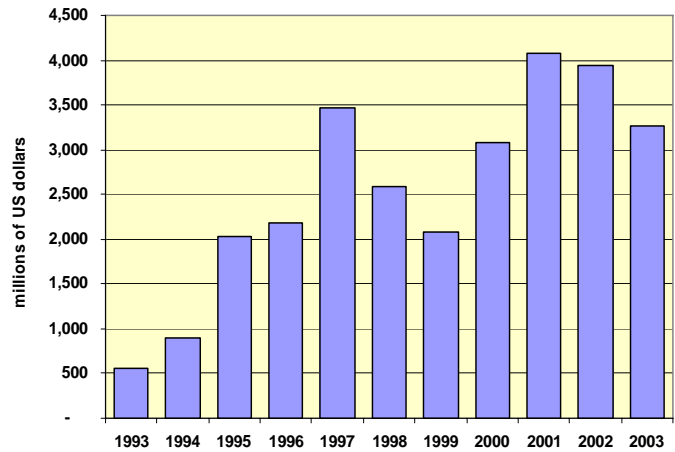
Accurate data on GDP in India over the past decade is hard to come by, but various sources estimate that India's GDP has grown at greater than 7.5% per year since 1995. The tables on the overleaf page show recent GDP growth and the enormous increase in foreign direct investment over the past decade.

GDP Growth in India



Source: U.S. Census Bureau, Bloomberg & CIA World Factbook

Foreign Direct Investment in India



Source: Bloomberg

The World is Flat

This, of course, is the title of Tom Friedman’s best selling book about globalization. His basic thesis is that the most important force currently shaping global economics and politics is the so-called triple convergence: hundreds of millions of new, well-educated players in developing nations; connected on an internet communications platform; developing new processes and entrepreneurial activity by horizontal collaboration. Friedman focuses on two nations: China and India. He gives numerous illustrations of how Indian companies are competing in the global economy. For example, there are approximately 250,000 Indians answering phone calls from the U.S. or other countries or making outbound calls to solicit business or ask about overdue bills. On another level, more than half a million U.S. tax returns are now prepared in India, after the necessary data has been scanned into servers in the U.S. On a more sophisticated level, General Electric has its second largest research center in Bangalore, India staffed by 1,700 Indian engineers, designers and scientists. And because of the excellent college and university system, India is rich in well-educated young professionals with financial, engineering and computer skills – all prepared to work for about 20% of the going rate in most Western capitals. If China is the place for outsourcing manufacturing, India is the nation for outsourcing every kind of service. How did this happen? The pre-conditions of this collaboration with Western nations were a mature, web-enabled internet; robust broadband capacity available because of the huge build-out of undersea fiber-optic cables before the technology bubble burst in 2000; the digitization of content; and a ready supply of English-speaking professionals. The seminal event was Y2K when U.S. companies needed huge amounts of software engineering to re-write their legacy computer systems, and Indian companies stepped into the breach. Now nearly every major U.S. multinational firm has a subsidiary in India, and there are more than a dozen Indian multinational companies as well.

The Indian Stock Market

How has the combination of economic reform, a huge middle class, triple convergence, and democratic capitalism been reflected in the Indian stock market? Have investors profited from the rapidly growing Indian economy? The Bombay stock exchange index is near an all-time high of 11,000, having more than tripled since 2003 as the chart on the following page illustrates:

Bombay Stock Exchange, 1997-2006



Does it make sense to invest in the Indian stock market now? Before describing the positive case for committing some funds to this stock market, it is important to understand the enormous problems still facing India. While there is a huge middle class, much of the population (perhaps 50%) remains in crushing rural poverty. Discrimination based on caste is officially outlawed, but there are still as many as 160 million Dalits (untouchables) relegated to the lowest jobs and subject often to social oppression. Economic growth is rapid (although not as great as China's). Faster growth in India is hampered by the poor infrastructure (roads, electricity, water, airports, etc.). There is constant tension with Pakistan, and in 2002, India came very close to war with Pakistan. Finally, there is a coalition government including several Communist and left wing parties currently running the country. The election in May, 2004 was the reason for the 40% drop in the Indian stock market before Sonia Gandhi, leader of the Congress Party, asked Manmohan Singh, the Alexander Hamilton of India, to become Prime Minister, thereby signaling that economic reforms would proceed.

Conclusion

While India is not without an array of challenges to overcome, there are many positive aspects to the emergence of India as a global economic power. First of all, it has maintained vital features of the British legacy: democracy, the rule of law, property rights, capitalism, and widespread knowledge of the global business language, English. Moreover, it has a well-educated workforce with great technological and commercial skills and an entrepreneurial spirit. It has a large middle class with a salary structure at a dramatic competitive advantage over the work force in Japan and the West. It is militarily powerful and is increasingly tied to the U.S. through commercial and national security interests. Voice and internet communications with the U.S. are almost instantaneous. Finally, its economy is growing about twice as fast as the U.S. and three times as fast as Europe's. All of this has not gone unnoticed by Indian and foreign investors. Foreign investors have poured billions of dollars into Indian stocks such as the top Indian technology service companies including Infosys, Wipro and Satyam. There are also U.S. mutual and closed-end funds which specialize in the Indian stock market. The Indian stock market is selling at its all-time peak price/earnings ratio of 21. Some investors believe a correction is overdue. Whether the timing is good at the moment or not, we at Bradley, Foster & Sargent, Inc. believe that the Indian story is compelling over the longer term, and we plan to follow this market closely to be ready to participate in the Indian stock market at a timely moment through mutual and closed-end funds and ADRs.