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Momentous changes in India's equity market microstructure will improve market efficiency and smooth volatility over time.

Emerging markets are frequently stereotyped as being prone to wild swings and outsized volatility. In particular, India has historically been a market where foreign institutional investment has driven the direction of the market - bearishness by foreign investors has almost always pushed markets downwards, while optimism abroad about India's prospects equally rockets equities to the stratosphere.

While sharp movements in either direction should not affect practiced value investors, the disproportionate impact of bipolar behaviour by international funds has both wreaked havoc in the Indian stock market, as well as created tremendous buying opportunities for the long-term value investor. For example, in 2014, when foreign investors pumped in over \$40 billion into the Indian market after voters handed a single party with a majority in the general election for the first time in 30 years, the benchmark Nifty index rose over 30%.

Now, changes are afoot that will make India's equity market more even-keeled over time. Employee Provident Fund Organisation (EPFO), an Indian government body, administers a pension fund drawing contributions from India's formal sector labour force and controls about Rs 8 trillion (US\$110 billion) in capital. In 2015, Prime Minister Narendra Modi's Indian government decided that for the first time in India's history, the corpus would be deployed in the equity market.

For its entire existence, EPFO had been investing heavily in debt securities. This was a system of indirect financial repression - the government would take workers' pension and invest it primarily into government bonds. In line with how pension funds are managed globally, the Modi government decided that 5-15% of EPFO's incremental corpus would annually be invested in exchange-traded funds tied to the major Indian market indices and a basket of government-owned enterprises. This is well below other large economies like Switzerland, where nearly 30% of pension money finds its way into the equity market, the United States (44%), and Australia (51%). EPFO's equity allocation would translate to Rs 80-120 billion (US\$ 1.2-1.5 billion) per year, and it invests in select ETFs that track India's two benchmark indices, the Nifty and the Sensex.

EPFO draws over \$12 billion a year in incremental funds from India's salaried workers. Given that foreign investors pumped in \$40 billion in 2014 and \$9.5 billion in 2015, the share of the EPFO corpus invested in equities is relatively small today. Nevertheless, the entry of a significant domestic institutional investor into India's equity market is a watershed moment. In its first year as an equity investor, the six decade-old EPFO parked 5% of the incremental corpus into ETFs. Late in 2016, it decided to increase the allocation from 5% to 10%, widening its mandate beyond large capitalization stocks to include mid-sized companies.

The Indian government is making a strong push to formalize the economy, and a burgeoning youth population means that EPFO's incremental corpus from which a chunk is invested in equities should rise over time. The government also wants to increase the percentage allocated to equities over time, and the presence of a long-term domestic permanent capital will bring much needed balance and stability to the Indian market.

This is possibly the biggest structural change the Indian market has seen in the last 25 years, comparable to when the Indian market was opened up to foreign investors. Bringing this corpus into equities wasn't an easy reform - powerful labour unions have resisted EPFO's entry into equity investing for decades, but this time the Indian government prevailed.

Given this momentous change, investors would do well to move away from old notions and biases about the foreign investor-induced hyper-schizophrenia of India's Mr Market. In practical terms, entry timing should matter less and volatility will be mitigated. The Indian market now has a new ballast. The permanent capital provided to equities by India's largest pension fund means that foreign developments can't whiplash Indian markets like they have in the past.