DRIEHAUS
CAPITAL MANAGEMENT

Driehaus Emerging Markets Small Cap Equity Strategy Summary

APRIL 2024

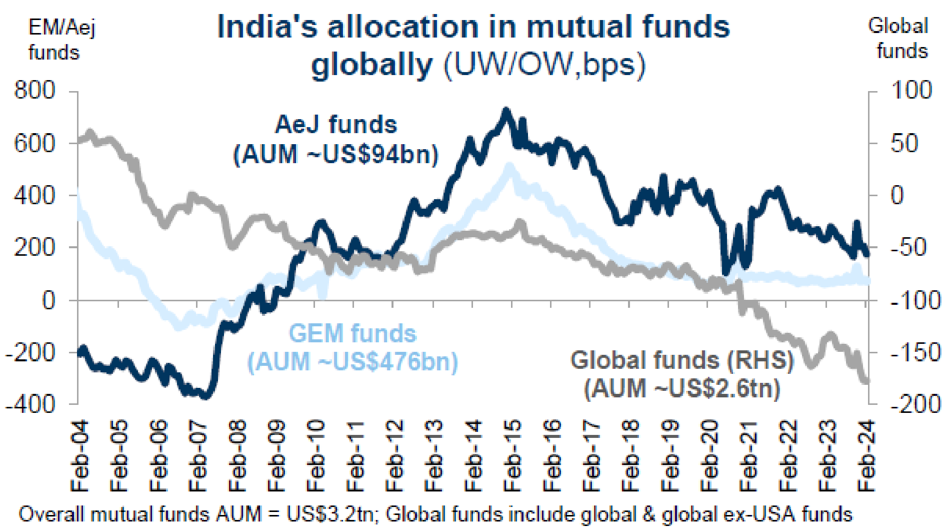
India has been one of the best performing equity markets in recent years, particularly in the small cap segment of the market, which has registered outperformance of over 1100 basis points per year relative to the MSCI All-Country World Small Cap Index over the last five years.

In fact, dating back to the initial election of Prime Minister Narendra Modi in May 2014, Indian small caps have handily outperformed even the S&P 500, generating annual returns of 14.3% over the period, relative to the S&P's 12.6%.

India is no longer an undiscovered equity market, having risen significantly in its index weighting over the years, to account for 26% of the MSCI Emerging Markets (EM) Small Cap Index. However, within the $1 trillion pool of global equity funds followed by Goldman Sachs, the India allocation is barely a rounding error at 0.5% of assets. Global Ex-US managers have only 2.8% of their $1.5 trillion in assets in India. Both of these weightings are below that of their respective benchmarks, suggesting scope for foreign inflows into Indian equities (Exhibits 1-2).

In our view, one of the strongest points of the case for a dedicated EM Small Cap allocation is the large exposure to India, which provides diversification in the context of a global equity portfolio, alongside a strong multi-year growth story.

Exhibit 1. India Allocation in EM, Asia, and Global Mutual Funds



Source: EPFR, FactSet, MSCI, Goldman Sachs Global Investment Research

Exhibit 2. India Allocation Relative to Benchmarks for Major Mutual Fund Categories

		India allocation		
Equity Mutual Funds	Total Assets (US$ bn)	Avg. Fund allocation (%)	Benchmark (MSCI)	OW/UW (bp) vs. MSCI
Global ex-USA funds	1,580	2.8%	4.9%	-210 bp
EM Funds	475	18.4%	17.6%	75 bp
Global funds	1,065	0.5%	1.8%	-130 bp
AEJ Regional funds	95	22.3%	20.5%	175 bp
Overall (AUM wgt.)	**$3,215 bn**	**4.9%**	**6.2%**	**-130 bp**

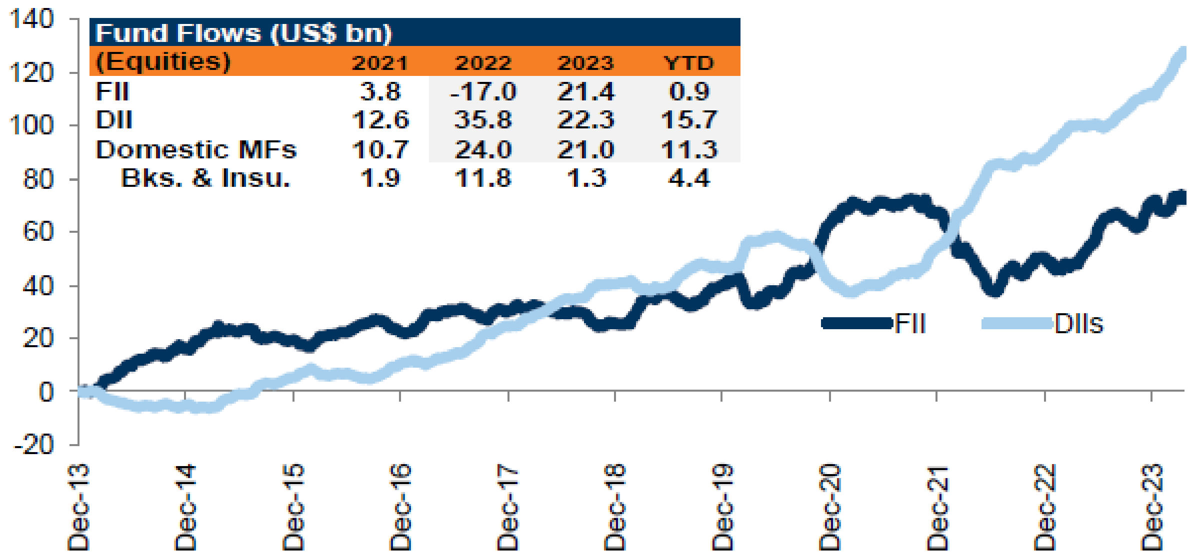
Source: EPFR, FactSet, MSCI, Goldman Sachs Global Investment Research. Note: As of Feb-end, 2024.

Nomura expects India to be the fastest growing major Asian economy in the coming years, growing at 7% per year through 2028. While any notion that GDP growth correlates to equity prices has been long debunked, we highlight three drivers below that we believe point to a strong performance outlook for Indian equities in the coming years.

First, India has a large pool of household savings, and only a small sliver of these savings are allocated into equities. Of the $600 billion in household savings in the country, physical assets such as property and gold comprise 61%, while financial assets account for 39%. However, only 8% of total household assets is invested in stocks and mutual funds.

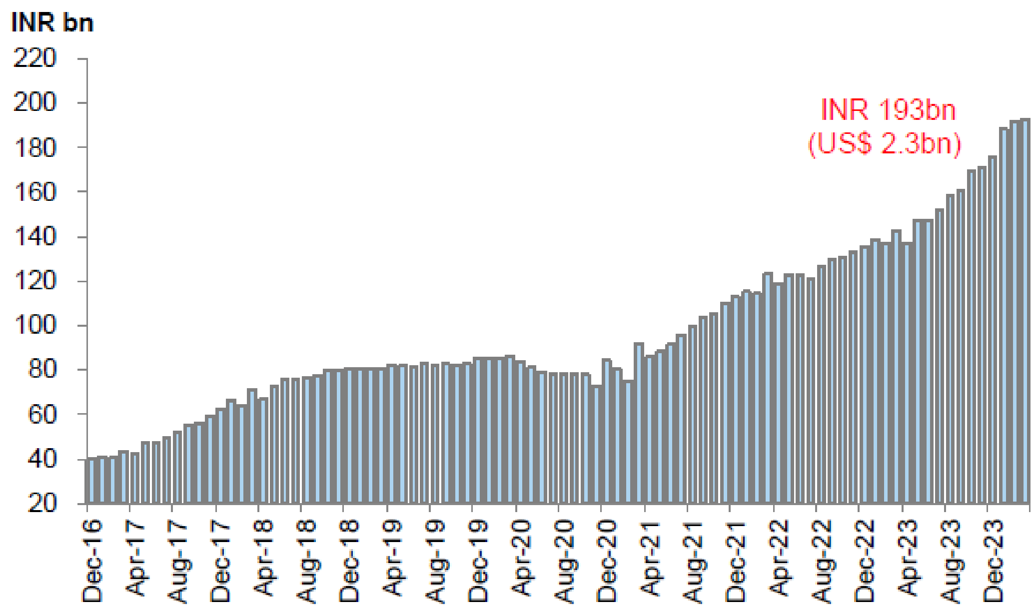
This percentage has been growing, and since the pandemic, domestic allocations into equities have picked up pace, with assets under management of domestic mutual funds doubling. Domestic flows into Indian equities have grown consistently since Modi was first elected, and we believe there is room for the domestic allocation to continue to increase (Exhibit 3). A meaningful driver of these domestic flows has been the advent of "Systematic Investment Products," or SIPs, which are instruments that households utilize to allocate a fixed amount of savings into equity markets on a monthly basis. As shown below, SIPs have provided consistent flows into Indian equities over the last seven years (Exhibit 4).

Exhibit 3. Cumulative Foreign Institutional Investor (FII) and Domestic Institutional Investor (DII) Flows into Indian Equities



Source: Bloomberg

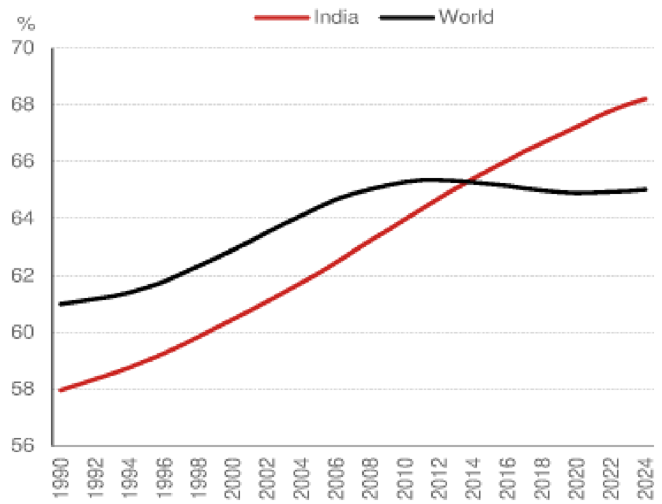
Exhibit 4. Monthly Flows into Domestic Mutual Funds Through SIPs



Source: AMFI, Data compiled by Goldman Sachs Global Investment Research

Second, India looks poised to benefit from a "demographic dividend," with the world's largest population, of which approximately 950 million are in the working age cohort. India's working age population is likely to continue to grow for the next 20-25 years, at a time when other countries face challenges associated with an aging population (Exhibit 5).

Exhibit 5. Working Age Population (%)



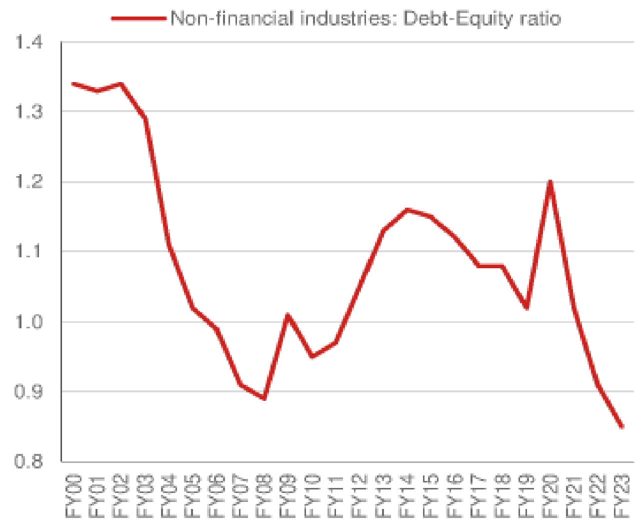
Source: United Nations and Nomura Global Economics

Notably, roughly 30% of India's workforce is concentrated in the agriculture sector. Given the strategic aims of the government to position India to become a larger player in manufacturing, we expect India's workforce to incrementally shift into areas that bring higher wages and higher productivity to the economy. This dynamic should, in turn, create a virtuous circle for consumption.

Third, India is amid a powerful investment cycle, encompassing nearly every segment of infrastructure spending, alongside private sector capacity expansion. During the last decade, India faced several constraints to investment growth. In the years prior to Modi's ascent, the term "policy paralysis," was an all too familiar part of the lexicon for investors in India.

Corporate India suffered from a prolonged hangover from taking on too much leverage in advance of the global financial crisis, and the accumulation of bad debts in India's public sector banks constrained credit growth. After a lengthy period of recovery, balance sheet health is much improved (Exhibit 6).

Exhibit 6. Debt/Equity Ratio of Indian Non-Financial Corporates



Source: CMIE and Nomura Global Economics

Post-pandemic, India's government has stepped up its investment in infrastructure. Central government capex ran at 1.7% of GDP pre-pandemic, and by comparison, the current budget for infrastructure is equivalent to 3.4% of GDP. On a bottom-up basis, we observe strong earnings growth across the board within the industrials sector, with companies focused on roads, rail, ports, airports, water, and power infrastructure showing marked acceleration in earnings and order backlogs.

The government's National Infrastructure Pipeline includes more than 9,000 projects encompassing $1.3 trillion worth of investment, suggesting several more years of growth to come. Modi's aim has been to enhance India's competitiveness on the global stage, and this is materializing at the same time that deteriorating geopolitical trends and demographics elsewhere have catalyzed supply chain shifts, with India increasingly positioned as a beneficiary of these trends.

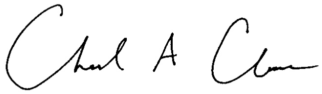
Notably, India recently commenced its 2024 national elections on April 19, where heavily favored incumbent Narendra Modi is seeking another term as Prime Minister. India's elections carry four phases, concluding on June 1, with results to be known by June 4.

Should Modi win, the next market catalyst is likely to focus on the investment cycle, as the final government budget would soon follow the election results. Modi's party, the BJP, recently issued an "election manifesto" highlighting the continuation of a number of key infrastructure priorities, including high speed rail, increasing access to residential natural gas, renewable energy, and making India a friendly destination for manufacturing.

The strategy maintains an overweight position relative to the benchmark, with a focus on companies in the industrials sector. Major positions include the operator of the Delhi International Airport, a manufacturer of railcars, a leading operator of container ports, and several power infrastructure names, with leading positions in transformers, smart meters, hydro power, and pumped storage. Beyond infrastructure, we continue to carry an overweight position in property developers, reflecting record affordability levels and the expectation of a prolonged property cycle, as supply struggles to keep pace with demand.

While Indian equity markets have enjoyed a strong decade of performance, global equity managers remain underallocated, at the same time domestic flows are gathering pace, amid what appears to be a structural shift of household savings into equities. In an EM context, uncertain growth and regulatory conditions in large markets such as China are likely to fuel investor appetite for areas with superior structural growth potential, with India being atop the list.

Until next month,



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