Nanubhai Desai & Co.

Foreign Portfolio Investments

About Nanubhai Desai & Co.

Nanubhai Desai & Co., established in 1950 in Mumbai, has evolved into a well-recognized high quality personalized services firm. Our extensive knowledge and expertise across various service areas, including Audit and Assurance, Direct Taxes, Accounting, International Tax, and Consultancy services, enable us to offer a "One Stop Platform" by setting a benchmark of excellence in each domain.

With years of experience, we cater to a diverse clientele, including multinational companies (MNCs), foreign companies and their Indian subsidiaries, as well as public and private enterprises spanning industries such as hospitality, trading, fund & private wealth management, IT, and more. Our team comprises dedicated professionals with diverse skills and proficiency, capable of serving clients of all sizes across different sectors.

NDCo embodies a harmonious mix of seasoned expertise and youthful vigour, united by a shared vision of delivering exceptional services and unwavering support to our clients. It's a source of great professional pride that we have attained high level of trust and confidence of our clients.

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TERMINOLOGY GUIDE

AI	Artificial Intelligence
AML	Anti-Money Laundering
DP	Depository Participant
DTAA	Double Taxation Avoidance Agreement
ETF	Exchange Traded Fund
FEMA	Foreign Exchange Management Act
FDI	Foreign Direct Investment
FII	Foreign Institutional Investor
FPI	Foreign Portfolio Investment
GDR	Global Depository Receipt
KYC	Know Your Customer
LEI	Legal Entity Identifier
PIS	Portfolio Investment Scheme
QFI	Qualified Foreign Investor
RBI	Reserve Bank of India
SEBI	Security Exchange Board of India
SPV	Special Purpose Vehicle

1. INTRODUCTION

Foreign Portfolio Investment (FPI) refers to the investment made by individuals, institutions, or entities in financial assets such as stocks, bonds, or other securities of a foreign country. Unlike Foreign Direct Investment (FDI), where investors acquire a significant stake in a foreign company with the intention of exerting control or influencing its management, FPI involves passive investments where the investor does not seek to actively manage or control the company.

a. Definition

Foreign Portfolio Investment (FPI) involves the purchase of securities in foreign financial markets by investors from another country. These securities can include stocks, bonds, mutual funds, exchange-traded funds (ETFs), and other financial instruments. FPI allows investors to diversify their investment portfolios internationally, potentially gaining exposure to new markets and asset classes.

b. Importance of FPI in Global Capital Markets:

→ *Diversification:* FPI provides investors with opportunities to diversify their portfolios geographically, spreading their risk across different countries and regions.

→ *Liquidity:* FPI enhances liquidity in financial markets by increasing the pool of funds available for investment. This liquidity can help improve price efficiency and reduce transaction costs.

→ *Capital Flows:* FPI contributes to capital flows between countries, facilitating the allocation of funds to where they are most needed or where they can generate the highest returns.

→ *Economic Development:* FPI can stimulate economic growth and development in recipient countries by providing access to foreign capital, expertise, and technology.

→ *Risk Management:* FPI allows investors to hedge against country-specific risks or economic downturns by diversifying their investments globally.

c. Overview of FPI vs. FDI:

→ FPI involves the purchase of financial assets such as stocks and bonds in foreign markets without seeking to exert significant control or influence over the underlying companies. It is typically more liquid and less permanent compared to FDI.

→ FDI, on the other hand, involves the acquisition of a substantial ownership stake (usually 10% or more) in a foreign company, with the intent of exerting control or influencing its management. FDI often involves long-term commitments and may include the transfer of technology, expertise, and management practices.

→ While FPI focuses on portfolio diversification and financial returns, FDI aims to establish a lasting presence in foreign markets and may involve strategic considerations such as market access, cost savings, or synergy with existing operations

2. TYPES OF FPI

a. Equity Investments:

→ Direct equity investments in listed companies: Investors can directly purchase shares of foreign-listed companies through stock exchanges. This allows them to own a portion of the company's equity and potentially benefit from capital appreciation and dividends.

→ Investment through equity mutual funds, exchange-traded funds (ETFs), and other equity instruments: Alternatively, investors can invest in foreign equities indirectly through equity mutual funds, ETFs, or other collective investment vehicles. These funds pool money from multiple investors to invest in a diversified portfolio of foreign stocks. ETFs are traded on stock exchanges like individual stocks, providing investors with easy access to diversified exposure to foreign equity markets.

b. Debt Investments:

→ Government securities, corporate bonds, and other fixed-income instruments: Investors can invest in foreign debt securities issued by governments, corporations, or other entities. These securities may include government bonds, corporate bonds, treasury bills, and other fixed-income instruments. Debt investments provide a regular income stream through interest payments and the return of principal at maturity.

→ Investment through debt mutual funds, bond ETFs, and structured products: Similar to equity investments, investors can also access foreign debt markets indirectly through debt mutual funds, bond ETFs, and structured products. These investment vehicles pool funds to invest in a diversified portfolio of foreign debt securities, providing investors with exposure to different types of fixed-income instruments and risk profiles.

3. BENEFITS OF FPI

a. Diversification of Investment Portfolio:

FPI enables investors to diversify their investment portfolios internationally, spreading their risk across different countries, regions, industries, and currencies. By investing in foreign markets, investors can reduce the impact of domestic market fluctuations and enhance portfolio resilience.

b. Access to Global Markets and Asset Classes:

FPI provides investors with access to a broader range of markets and asset classes beyond their domestic boundaries. This access allows investors to capitalize on opportunities in foreign markets that may offer higher growth potential, unique investment opportunities, or access to specialized industries or sectors.

c. Potential for Higher Returns Compared to Domestic Investments:

Investing in foreign markets can potentially yield higher returns compared to domestic investments, especially in markets experiencing rapid economic growth or where specific sectors are thriving. By diversifying globally, investors can capture returns from multiple sources and benefit from differences in market cycles and economic conditions.

d. Liquidity and Ease of Entry and Exit:

Foreign markets often offer high liquidity, allowing investors to easily buy and sell securities without significant price impact. Additionally, with advancements in technology and financial infrastructure, accessing foreign markets has become increasingly convenient and cost-effective, providing investors with flexibility in entering and exiting positions according to their investment objectives and market conditions.

4. RISKS ASSOCIATED WITH FPI

a. Market Risk:

→ Volatility in global financial markets: Foreign markets may experience higher levels of volatility compared to domestic markets due to factors such as geopolitical events, economic indicators, and market sentiment.

→ Currency risk and exchange rate fluctuations: Changes in exchange rates can affect the value of foreign investments when translated back into the investor's home currency. Fluctuations in currency exchange rates can either enhance or diminish investment returns.

b. Country Risk:

→ Political instability and regulatory changes: Political instability, changes in government policies, and regulatory environments can impact foreign investments. Uncertain political climates or unexpected regulatory changes may lead to sudden market disruptions or changes in investment conditions.

→ Economic downturns and sovereign credit risk: Economic downturns, fiscal imbalances, or sovereign debt crises in foreign countries can adversely affect the performance of investments. Sovereign credit risk refers to the risk of default on government debt obligations, which can affect bond prices and interest rates.

c. Liquidity Risk:

→ Limited liquidity in certain markets and asset classes: Some foreign markets or asset classes may have limited liquidity, making it difficult for investors to buy or sell securities at desired prices or volumes. Illiquid markets can lead to wider bid-ask spreads and increased transaction costs.

→ Impact of market liquidity on investment performance: Changes in market liquidity conditions can impact investment performance, especially during periods of market stress or heightened volatility. Reduced liquidity can exacerbate price fluctuations and increase the risk of slippage during trade execution.

d. Counterparty Risk:

→ Risk of default by issuers or intermediaries: Investors face counterparty risk when dealing with issuers of securities or intermediaries involved in investment transactions. The risk of default by counterparties can result in financial losses or disruptions to investment activities.

→ Credit risk associated with counterparties in derivative transactions: Derivative transactions involve counterparties, and credit risk arises if the counterparty fails to fulfil its obligations. Credit risk in derivatives can affect the value of derivative contracts and expose investors to potential losses.

5. REGULATORY FRAMEWORK FOR FPI

a. Regulatory Authorities Governing FPI:

→ Securities and Exchange Board of India (SEBI): SEBI is the primary regulatory authority for the securities market in India. It regulates FPI through various regulations, guidelines, and circulars aimed at promoting transparency, investor protection, and market integrity.

→ Reserve Bank of India (RBI): RBI plays a significant role in regulating foreign exchange transactions and managing the country's foreign exchange reserves. It issues regulations and guidelines related to FPI investments, including foreign exchange management regulations and investment limits.

→ Ministry of Finance: The Ministry of Finance, through its departments and agencies, formulates policies and regulations governing FPI in consultation with SEBI, RBI, and other relevant authorities.

b. Registration and Eligibility Requirements for Foreign Investors:

→ Foreign investors interested in participating in the Indian securities market need to register with SEBI as Foreign Portfolio Investors (FPIs). Eligible entities for FPI registration include foreign institutional investors (FIIs), qualified foreign investors (QFIs), and others as per SEBI regulations.

→ FPI applicants must fulfil eligibility criteria, including regulatory requirements, compliance with anti-money laundering (AML) and know your customer (KYC) norms, and adherence to investment limits and sectoral caps.

c. Investment Limits, Sectoral Caps, and Reporting Obligations:

→ SEBI and RBI prescribe investment limits and sectoral caps for FPIs based on their registration category, investment objectives, and risk appetite. These limits define the maximum permissible exposure to various securities, sectors, and asset classes.

→ FPIs are required to comply with reporting obligations such as periodic disclosures, transaction reporting, and regulatory filings to SEBI, RBI, and other regulatory authorities. These reports help ensure transparency, monitor compliance, and assess market risks.

d. Compliance with Know Your Customer (KYC) and Anti-Money Laundering (AML) Norms:

→ FPIs are required to comply with KYC and AML norms, which involve due diligence procedures to verify the identity of investors, assess their risk profiles, and prevent money laundering and terrorist financing activities. SEBI and RBI mandate stringent KYC and AML requirements for FPI registration and ongoing compliance.

6. GLOBAL TRENDS AND STATISTICS IN FPI

a. Trends in FPI Flows and Asset Allocation by Region and Asset Class:

→ FPI flows vary across regions and asset classes based on factors such as economic conditions, market sentiment, and investment opportunities. Developed markets like the United States, Europe, and Japan attract significant FPI inflows due to their stable economies, robust financial markets, and liquidity.

→ Emerging markets, including China, India, Brazil, and others, also attract FPI inflows, albeit with higher volatility and risk. These markets offer growth opportunities, diversification benefits, and higher yields compared to developed markets.

→ Asset allocation within FPI portfolios may include equities, bonds, money market instruments, and alternative investments. Equity investments are typically favoured for potential capital appreciation, while fixed-income securities provide income and portfolio diversification.

b. Comparative Analysis of FPI vs. FDI Flows and Investment Patterns:

→ FPI and Foreign Direct Investment (FDI) represent two distinct forms of foreign investment with different objectives and characteristics. FPI involves passive investments in financial assets, while FDI involves acquiring a significant ownership stake in foreign companies.

→ FPI flows tend to be more volatile and short-term compared to FDI, which often involves long-term commitments and strategic investments. FPI flows are influenced by factors such as market sentiment, global economic conditions, and interest rate differentials.

→ FDI flows are driven by factors such as market access, technology transfer, strategic alliances, and government policies. FDI often plays a crucial role in promoting economic growth, infrastructure development, and job creation in recipient countries.

c. Impact of Macroeconomic Factors, Geopolitical Events, and Monetary Policies on FPI Trends:

→ FPI trends are influenced by various macroeconomic factors, including GDP growth, inflation rates, interest rates, and fiscal policies. Positive economic indicators and favourable policy environments generally attract FPI inflows, while economic downturns or policy uncertainties may lead to outflows.

→ Geopolitical events, such as trade tensions, geopolitical conflicts, and regulatory changes, can create volatility and uncertainty in global financial markets, affecting FPI flows and asset prices.

→ Monetary policies, including central bank actions such as interest rate decisions, quantitative easing, and liquidity injections, can impact FPI trends by influencing investor sentiment, risk appetite, and capital flows across borders.

7. BEST PRACTICES & INVESTMENTS STRATEGIES FOR FPI

a. Portfolio Diversification Strategies for FPI Investors:

→ Diversification across regions, countries, sectors, and asset classes is a fundamental strategy to mitigate risk and enhance risk-adjusted returns in FPI portfolios.

→ FPI investors should consider allocating their investments across different geographic regions and economies to reduce exposure to country-specific risks and market volatility.

→ Asset allocation strategies should balance risk and return objectives, taking into account factors such as investment horizon, risk tolerance, and market conditions.

b. Risk Management Techniques and Hedging Strategies:

→ FPI investors can employ various risk management techniques and hedging strategies to mitigate market, currency, and geopolitical risks.

→ Hedging currency risk through derivatives such as forward contracts, options, or currency swaps can help protect investment returns from adverse exchange rate movements.

→ Risk management tools such as stop-loss orders, limit orders, and portfolio rebalancing can help investors monitor and adjust their positions in response to changing market conditions.

c. Active vs. Passive Investment Approaches in FPI:

→ FPI investors can adopt either active or passive investment approaches based on their investment objectives, risk tolerance, and market views.

→ Active investment strategies involve actively selecting and managing individual securities or portfolios to outperform the market benchmarks. Active managers rely on research, analysis, and market timing to generate alpha.

→ Passive investment strategies, such as index investing or ETFs, aim to replicate the performance of a specific market index or asset class. Passive investors seek to capture market returns at a lower cost with minimal portfolio turnover.

d. Importance of Due Diligence and Investment Research in FPI Decision-Making:

→ Due diligence and investment research are critical for FPI decision-making to assess investment opportunities, evaluate risks, and make informed investment decisions.

→ FPI investors should conduct thorough research on target markets, industries, and individual securities to understand their fundamentals, valuations, and growth prospects.

→ Analysis of macroeconomic factors, geopolitical events, regulatory environments, and market trends can provide insights into potential risks and opportunities in FPI portfolios.

8. CHALLENGES AND OPPORTUNITIES IN FPI

a. Challenges:

i. Regulatory Uncertainties and Compliance Burdens:

→ FPI investors face regulatory uncertainties and compliance burdens related to changing regulations, tax policies, and reporting requirements in foreign jurisdictions.

→ Compliance with multiple regulatory frameworks across different countries can be complex and resource-intensive, increasing operational costs and administrative burdens for investors.

ii. Market Volatility and Unpredictable Macroeconomic Conditions:

→ FPI is exposed to market volatility and unpredictable macroeconomic conditions, including fluctuations in exchange rates, interest rates, and geopolitical events.

→ Uncertainty surrounding global economic growth, trade tensions, and policy shifts can create volatility in financial markets, impacting investment returns and portfolio performance.

b. Opportunities:

i. Access to High-Growth Emerging Markets:

→ FPI provides investors with opportunities to access high-growth emerging markets with attractive investment prospects, demographic trends, and growing consumer demand.

→ Emerging markets offer diversification benefits, potential for higher returns, and exposure to sectors and industries poised for growth, such as technology, healthcare, and consumer goods.

ii. Potential for Alpha Generation Through Active Management:

→ Active management in FPI allows investors to seek alpha by identifying mispriced securities, exploiting market inefficiencies, and capitalizing on short-term opportunities.

→ Skilled portfolio managers can add value through research, analysis, and disciplined investment strategies, outperforming passive benchmarks and generating excess returns for investors.

iii. Technological Advancements and Innovation in FPI Platforms:

→ Technological advancements and innovation have transformed FPI platforms, providing investors with access to real-time market data, trading tools, and investment analytics.

→ Electronic trading platforms, algorithmic trading, and artificial intelligence (AI) technologies enable faster execution, improved risk management, and enhanced decision-making in FPI.

→ capital flows across borders.

What support do we offer?

→ Providing guidance on regulatory requirements and compliance obligations related to FPI, including registration, reporting, and disclosure norms mandated by regulatory authorities such as SEBI and RBI.

→ Assisting clients in navigating complex regulatory frameworks, ensuring adherence to KYC, AML, and other regulatory norms, and facilitating regulatory filings and submissions.

→ Advising clients on optimal investment structures, tax-efficient strategies, and jurisdictional considerations for FPI, taking into account tax treaties, withholding tax obligations, and cross-border tax implications.

→ Structuring investments through appropriate vehicles such as FPI entities, offshore funds, or special purpose vehicles (SPVs) to minimize tax liabilities and optimize investment returns.

→ Assessing and mitigating risks associated with FPI, including market risk, currency risk, country risk, and counterparty risk, by implementing risk management techniques and hedging strategies.

→ Designing customized risk management solutions tailored to clients' risk profiles, investment objectives, and exposure to foreign markets and currencies.

→ Providing financial reporting services compliant with accounting standards and regulatory requirements for FPI investments, including fair value measurement, impairment assessment, and financial statement disclosures.

→ Conducting valuation exercises for FPI portfolios, assessing the fair value of investments, and providing independent valuation opinions for regulatory compliance, financial reporting, or transaction purposes.

→ Evaluating the performance of FPI portfolios, benchmarking against relevant indices or peer groups, and providing performance attribution analysis to assess the contribution of various factors to investment returns.

→ Conducting portfolio analytics, risk profiling, and scenario analysis to optimize asset allocation, enhance portfolio diversification, and align investment strategies with clients' risk-return objectives.

→ Offering transaction support services for FPI transactions, including due diligence, deal structuring, transaction documentation review, and negotiation support to facilitate successful investment transactions.

→ Conducting comprehensive due diligence on target investments, assessing legal, financial, tax, and providing insightful recommendations to clients for informed decision-making.

→ Providing strategic advisory services on FPI opportunities and challenges, market trends, investment themes, and sectoral analysis to help clients formulate investment strategies aligned with their financial goals and risk appetite.

→ Offering proactive advice on asset allocation, portfolio rebalancing, and tactical asset allocation decisions based on changing market conditions, economic outlook, and client preferences.

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