

RESEARCH PAPER

PRODUCTS
(TAKING STOCK)

India – all the Raj

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It's not a case of India OR China, it's India AND China - welcome to Chindia. This paper examines why India offers some of the best investment opportunities within emerging markets, and yet is often overshadowed by China. It sets out the factors driving economic growth in India, including the opportunities and risks, and debates why and how India should be a key component of investors' exposure to emerging markets, arguing that investors should not limit themselves to just one leg of the BRIC/emerging markets story.

Common international benchmarks continue to underrepresent emerging markets. Emerging markets constituted only 7.4% of the MSCI All Country World ex-Aust Index and 0% of the MSCI World ex-Aust Index as at 30 June 2006. Yet, emerging markets are becoming an increasingly important factor in world dynamics, and now represent 51% of the world economy in purchasing power parity terms.¹ It is therefore vital that investors understand the factors driving this increasingly important investment opportunity, and are positioned to benefit from the associated growth. While China has been widely discussed and analysed, the relatively unheralded rise of India offers some of the best long-term investment opportunities within emerging markets.

So what is all the Raj about?

India is the world's most populous democracy, home to 1.1 billion people, approximately one sixth of the world's population. Given India's large land mass, a high proportion of the population live in rural areas and are therefore dependent on agriculture as their primary source of income. Increasingly, these rural populations are relocating to urban areas, and the inequality of rural and urban incomes is a pressing economic issue. It is estimated that 260 million Indians survive on less than \$US1 a day. This inequality was a major factor in the surprise election defeat of the Bharatiya Janata Party (BJP) led government in May 2004.

The stage is now set for India to claim its rightful place as one of the most exciting investment opportunities of the next decade. India has quietly been gaining greater recognition from investors, who pumped a record \$US11 billion into the local market in the year ending 31 March 2006. A healthy and necessary market correction in May 2006 saw foreign investors sell a net \$US2.4 billion, but investors are already creeping back. India is also being courted by a growing number of foreign dignitaries who view it as a potential trade partner and political ally in the region. President George Bush, President Jacques Chirac, King Abdullah of Saudi Arabia and Prime Minister John Howard each made trips to India in 2006.

The Indian economy continues to grow strongly. GDP grew 8.4% year-on-year to 31 March 2006 driven by strong domestic demand. Although growth is expected to decrease slightly in the coming year, the overall trend remains impressive, with growth over the last 15 years averaging above 6% per annum. India was second only to China for GDP growth over this period.

The Indian fiscal deficit also improved slightly to 4.1% of GDP. While exports continue to grow, up 22%, this has been offset by a large increase in demand for imports, up 33%. For the fiscal year ending 31 March 2006, the trade deficit jumped to a record \$US39.6

Figure 1: India quick facts (world ranking)

POPULATION	1.1 billion (2nd)
AREA	2.2m sq km (7th)
DENSITY	329/km ² (20th)
LANGUAGES	Hindi, English + 17 other official
RELIGIONS	Hinduism, Islam, Christianity, Sikhism, Buddhism, Jainism
LIFE EXPECTANCY	64 years (m) / 66 years (w)
MEDIAN AGE	24.9 years
CAPITAL	New Delhi
INDEPENDENCE	15 August 1947
GOVERNMENT	Federal Republic
PRIME MINISTER	Dr Manmohan Singh
PRESIDENT	APJ Abdul Kalam
CURRENCY	Rupee
EMBLEM	Sarnath Lion
ROAD NETWORK	3.3 million km (2nd)
MOVIE PRODUCTION	1000 per year (1st)
MOBILE PHONES	69 million (6th)
INTERNET USERS	51 million (4th)

Source: CIA World Factbook, BBC, Time Magazine¹, IBEF



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billion. The current account deficit, taking into account invisibles (including remittances by overseas Indian workers and software exports) is approximately \$US30.4bn or 3.6% of GDP. Overall though, the balance of payments remains positive. The current account deficit has been offset by the capital account, which has benefited from strong foreign investment flows into the stock market. Foreign exchange reserves now stand at an estimated \$US160bn.

India has averaged GDP growth of over 8% for the last three years. If the government is able to tackle some structural issues, particularly infrastructure, many analysts believe GDP growth could potentially reach low double digits. Goldman Sachs (2003) predicted India will be the third largest economy in the world by 2050.³ Encouragingly, current growth rates are already above those assumed in the Goldman Sachs study.

Key drivers of Indian economic growth include private enterprise, a strong business infrastructure, demographics, a robust service sector (the rise of outsourcing), untapped opportunities including retailing, and consumption (rising incomes).

Private versus Public

India has followed a gradual and consensual approach to reform, with an emphasis on evolving a well developed institutional framework. In contrast to other high-growth economies, the State has played almost no direct role in India's recent growth. Nor has it displayed preferences for any particular sectors – indeed the Government has historically posed an equally heavy burden on all firms. However, of late it has aided industry by demanding less, not by showering businesses with favours. Privatisation and deregulation, not intrusive industrial policy, represent the State's biggest contribution to India's recent growth. Freed from State direction, the Indian economy has developed a service focus. In other emerging markets, government policies push manufacturing to the forefront and the service sector remains underdeveloped in most of South East Asia. In India, computer programming, back-office outsourcing and call centres flourish, in part because the State did not divert capital to manufacturers. No other country at India's level of development boasts a globally competitive service industry (excepting tourism).

Business infrastructure vs physical infrastructure

While India may not possess the shiny new physical infrastructure of China, it has a key advantage in terms of business infrastructure. India has a robust banking system that is well managed and regulated. India's banks have been conservative in their lending and the percentage of non-performing loans is low. Relatively efficient capital markets and an independent judiciary which recognises intellectual and physical property rights further support the business community. India's English language skills also give it a competitive advantage over many of its peers when seeking to do business with overseas investors. While less visible than physical infrastructure development, the importance

of these developments should not be underestimated in generating an environment in which business and commercial interests can drive India's growth model.

The human factor

Another vital aspect of India's growth model is its large reserves of human capital. India already has 17% of the global working-age population and will add a further 83 million workers by 2010 compared to 0.1 million for Europe and a decline of 3 million in Japan. India has a very young population with 55% under the age of 24. While China's age dependency ratio is currently lower than that of India, this will reverse by around 2025 at which point, China will suffer a sharp rise. The age dependency ratio of the US and Europe will start deteriorating significantly from 2010. In contrast, India's ratio will continue to fall. This further emphasises the importance of India in global trade dynamics – it will be home to a large proportion of the workers and consumers of tomorrow.

Another important factor in India's human capital is its relatively high education standards, at least at tertiary level. About 8% of the Indian population between the ages of 25 and 34 have attained a tertiary qualification, compared to 5% in China.⁴ Another key advantage is that the majority of degrees are instructed in English. India adds approximately 2.7 million graduates annually, and is ranked seventh among 60 nations in terms of availability of skilled labour and first for the availability of qualified engineers to which it adds 300,000 new graduates each year.⁴

Serviced in India

At a very simplistic level, one of the main differences distinguishing India's growth model is its unusually large servicing sector compared to other emerging markets. Compared to more traditional emerging markets, India is much more of a domestic growth story, fuelled by an entrepreneurial spirit with less direction from the State and less reliance on foreign direct investment (\$US8.4bn last year). Ultimately, these differences have led to India evolving an economy driven primarily by the services sector.

One sector that epitomises this difference is the IT services sector. It is synonymous with the Indian growth story and provides a useful case study of India's entrepreneurial spirit. The birth of the sector can be traced back to the 1965 war with Pakistan when the US, in support of its ally, decided to halt the provision of electronics to India. This promoted the development of home grown expertise, and a need to be self sufficient in the production of medium-sized computers and, importantly, software. As the need for more advanced systems became apparent, the market was opened again to foreign companies. By the early 1970s, IBM was allowed to operate freely in India, controlling nearly 75% of the market. Again, a political decision was to change the landscape. New rules forcing foreign IT companies to hand over technology to Indian companies forced IBM and other

foreign companies to close up shop and leave India. Initially, the impact was devastating. However, much of the expertise and knowledge was retained in India, with new companies set up by ex-employees to support and service old computers. In particular, software for the incumbent technology was written domestically using freely available operating systems such as Unix. This knowledge and software expertise would prove to be a spur for a new industry. As the use of computers spread in developed markets, the demand for software applications increased dramatically. Many of these software packages used derivatives of the Unix system, something Indian software engineers were familiar with and adept at utilising.

A further boost was provided by the liberalisation of the software and computer industry in the mid 1980s by then Prime Minister Rajiv Gandhi, a technology enthusiast. This saw new entrants emerge with Satyam, Wipro, Infosys and Tata Consulting developing into IT and software companies. Prior to this, Satyam's focus had been on the retailing of computers, while Wipro, short for West Indian Vegetable Processing Company, originally produced cooking oil. These new companies would go on to become major global players in the IT and software industry.

This ascendancy was further aided by three key developments: the Y2K millennium bug (given India's need to maintain and develop older systems and software, following the withdrawal of IBM in the 1970s, its engineers were highly experienced and qualified to address this need); the formation of global information superhighways (the availability of high speed data networks and the introduction of fibre optic cabling and the Internet meant geography was no longer a barrier to markets); and, cost benefit (as companies in developed markets have become increasingly focused on cutting costs, outsourcing back office has become increasingly appealing – Indian labour is a fraction of the cost of developed markets with the average annual salary of a software engineer in 2005 just \$US7,010 and there has been a steady stream of English speaking, highly qualified workers to meet demand.)

Today, India's software and IT-enabled services industry is home to a number of globally competitive companies. In 2005, the sector produced revenues of \$US36 billion, up 28% on 2004. It accounts for approximately 5% of GDP and is predicted to be 7% of GDP by 2010.⁵

The initial attraction for global corporations in outsourcing low-valued processing tasks to India was cost. And yet India's "call centre of the world" tag is becoming outdated. Successful IT-enabled service companies have been quick to move up the value chain, offering a range of business process outsourcing (BPO) activities such as purchasing and ordering functionality, procurement, accounting, insurance management, human resource and benefits management, medical, actuarial and legal functions. Today, India's IT services include everything from software programming

and multi-media platforms to systems support and network management. Nor has the sector reached saturation. A McKinsey survey suggests only one ninth of IT outsourcing potential and one twelfth of BPO outsourcing potential has been realised.

Further opportunities also lie in knowledge process outsourcing (KPO) including insurance claim assessment and legal work. Medical tourism, whereby patients travel to India for cheap medical care and operations, is another opportunity.

However, despite the undoubted strength of India's IT and servicing sectors, India should not be seen as a one trick pony. It has also been successful in developing a pharmaceutical industry. Initially focussing on generic drug manufacturing, the adoption of World Trade Organisation (WTO) standards for patents has led to a boom in R&D investment. In total, over 125 Fortune 500 companies now have R&D operations in India. India is also increasingly developing a manufacturing sector, particularly in the food processing segment.

Selling – the opportunity

One of the potential areas of growth for India over the next decade is organised retailing, given the increasing appetite for domestic consumption and the fragmented nature of the sector at present. Organised retail in India accounts for just 3% of its \$US250bn retail industry. The nearly 15 million retail outlets are dominated by small family-owned businesses, 96% of which have a floor space less than 500 square feet. However, organised retailing is growing at 18% to 20% a year, attracting the attention of domestic and international suitors. International retailing heavyweights are being held back at the borders with the retailing sector effectively closed to foreign investors. Foreign companies continue to lobby for access to the lucrative market but are currently restricted to wholesaling, and up to 51% ownership in single brand retailing operations. This gives domestic players the opportunity to seek first mover advantage and establish store networks prior to a foreign invasion. One of the first domestic players to seize this opportunity is Reliance, better known as an industrial giant. It has announced plans to build over 2000 hypermarkets, with up to 200,000ft² of floor space, 2000 supermarkets up to 2,000ft², and 60 supply centres in the next two years. Bharti Enterprises, an affiliate of Bharti Televentures, the operator of the country's largest mobile phone network, has similarly ambitious plans. Infrastructure will play an important part in this development. Retailers need an efficient transportation system to move goods to market in a timely and cost effective manner. It is estimated that currently up to 40% of fruit and vegetables rot on the way to market in India.⁶ In part, these limitations are behind Reliance's plan to equip some of their supply centres with private airstrips. Indeed, it may be the growth of this sector and its dependence on physical infrastructure that provides the additional advantage of private investment funding in building roads and railways, in part relieving the State of the burden.

The growth of this sector could provide yet another boon for employment, forming new growth industries outside the incumbent IT and software sectors. Already the second largest provider of jobs, behind agriculture, the investment by Reliance alone could potentially create 500,000 new jobs in the retail sector, providing vital employment opportunities for Indian's growing army of semi-skilled young workers.

However, the allure of mass retailing and off the peg fashion may take time to develop. Equally, in rural areas where incomes remain low, many shoppers only buy daily supplies, choosing to buy items such as toiletries, and food products in small individual sachets that cost a few cents each. Sachet sales still account for 70% of the \$US200 million shampoo market in India. Retailers can also learn from McDonalds, which adapted its menu to meet local tastes introducing McCurry Pan and McAloo Tikka. McDonald's Indian restaurants serve on average over 3000 hungry diners a day, and are among the most profitable in the world.

Consumption

The appetite for goods and services continues to grow. Domestic consumption is potentially a further support to the Indian economy. A strong domestic economy is vital to the long-term aspirations of any emerging market, as ultimately it can provide higher quality and more sustainable growth less dependent on external factors. With a growing middle class population and rising incomes, India has one of the largest consumer markets in the world, and private consumption in India already accounts for 64% of the economy, more than in Europe, Japan and China.

Yet in terms of product penetration, India is starting from a low base compared to many of its global peers (Figure 2)⁷ – and therein lies the opportunity. Construction of over 450 shopping malls, increasing incomes and the mass of relatively undergeared young consumers means the consumption story is a key and growing part of the long-term Indian growth story. The National Council for Applied Economic Research estimates there are 56 million people in households earning \$US4,400 to \$US21,800 per year, which it

defines as middle class. As incomes increase, this will rise quickly.

The challenges ahead

Like most emerging markets, India is vulnerable to surges in oil prices and the inflationary pressure this can bring, and currency issues, particularly in relation to the US dollar. There are also issues more specific to India and its ability to meet its growth targets.

Capital – India continues to suffer from a lack of capital to invest in infrastructure. One of the key reasons for the high growth in Asia (ex India and Japan) in the 1990s was the high savings rates of around 35% of GDP. However, in India, savings rates are 24% of GDP, and foreign direct investment (FDI) inflow is low relative to GDP, restricting capital formation. In order to reduce India's revenue deficit, currently 4.1% of GDP, the government has been steadily cutting expenditure on areas such as education, health and welfare. The government has also maintained a higher level of indirect taxes.

Infrastructure – Lack of capital for investment in infrastructure is a potential problem. Unlike China which has pumped huge investment into improving infrastructure, India has invested relatively little to date on expanding capacity and upgrades. This adds additional cost to producing and transporting goods both internally and externally, reducing efficiencies and partially offsetting labour cost gains. This is probably the single most important macro constraint curtailing India's economic growth.

In an attempt to address this, India recently completed the Golden Quadrilateral Highway connecting Delhi, Kolkata, Mumbai and Chennai. This is the tip of the iceberg. Of 65,000km of highway in India, only 9% is dual carriageway, while over a third of roads serving India's villages remain unsealed.

Nor are the infrastructure limitations exclusive to transportation. One of the more pressing areas is the availability of electricity. Peak supply falls 11% short of demand, and up to one third of production is lost or stolen from the grid. More worryingly, 56% of households are yet to connect to the national grid, providing yet more pent up demand. The required expenditure by the State to ensure fresh drinking water and modernisation of rail network, seaports and airports, is estimated at \$US100 billion per year if growth targets are to be maintained. Public/private initiatives will become increasingly important.

Education and healthcare – While at a tertiary level, education standards are very impressive, the same cannot be said for primary and secondary education. Facilities and pupil-to-teacher ratios are some of the poorest in the world, again in part as a symptom of under-investment, and in part India's rigid caste system. Only 79% of children complete their primary education while only 54% of over 10-year-olds enrol

Figure 2: Consumption – durables penetration per 1,000 people

COUNTRY	CARS	2-WHEELERS	TVS	PCS	MOBILE PHONES
INDIA	6	53	83	7	52
CHINA	12	26	350	28	269
BRAZIL	64	28	349	75	263
FRANCE	491	40	632	347	647
JAPAN	428	106	785	382	637
MEXICO	107	na	282	82	na
USA	480	15	938	658	488

Source: CLSA⁷

in secondary education. These poor attendance records have resulted in a 39% illiteracy rate in India, compared to 9% in China. If India is to ensure it has sufficient educated workers to meet growing demand, it needs to invest more in basic levels of education.

In a little publicised fact, India is also home to the highest number of HIV-infected people in the world, at an estimated six million. This, coupled with poor healthcare in rural areas, is a crisis in the making. The World Health Organisation ranks the Indian health system 112th out of 191 countries.

Monsoons/Agriculture – Despite the emergence of new growth drivers in the Indian economy and the changing composition of GDP, agriculture still plays an important role in India's economy, albeit a decreasing one. Most new job opportunities and growth industries are centred in urban areas, however the majority of the population continues to reside in rural areas, with approximately two-thirds of the population dependent upon agriculture as their primary source of income. While agriculture growth is very modest, averaging 2% to 3% per year, it is dependent on good monsoons. Two consecutive years of poor rains would have a slight impact on growth and could affect overall sentiment.

Red tape – While the State has interfered little in some aspects of the Indian economy, allowing private enterprise to dictate the course of India's growth, the country remains heavily bogged down in bureaucracy and red tape. Although India has broadly cut import duties and increased foreign ownership limits over 10 years, large sections of the economy remain closed off by high tariffs and restrictions on foreign direct investment. Red tape also hinders development and operation of new Indian businesses. The World Bank's 2006 survey on the ease of doing business in 155 countries ranked India a low 116th, two places below Iraq and 25 places below China. In particular, archaic labour laws supported by the left continue to strangle Indian businesses. While India's transition from red tape to red carpet may be a few years away, the Congress party continues to make small steps to open up markets to valuable foreign investment, despite opposition from more left wing parties. Most observers would like to see this issue tackled with more vigour.

Riding the elephant

To date, India's growth rate has lagged that of other emerging markets, but it has developed a strong foundation for future growth, one that may ultimately prove to be more sustainable and less volatile. While the tigers and dragon may have won the sprint, the Indian elephant is well positioned for the marathon.

India offers some of the most accessible investment opportunities in the emerging market universe. It has a diverse and well regulated market structure. There are approximately 4500 listed companies in India, second only to the US. In general, companies are very well managed, with much greater focus on adding

shareholder value and maximising profits rather than simply seeking to increase market share, as is often the case in the rest of South East Asia. Indian companies also have a higher return on equity (ROE) than many of their counterparts in Hong Kong, Singapore, Korea, Taiwan, Japan, Malaysia, and Chinese companies listed in HK. Remarkably, Indian companies combine high ROEs with one of Asia's lowest debt to equity ratios. These factors make the Indian market highly attractive to stock pickers. When this is combined with the strength of India's institutional framework, there is a compelling investment environment. A well developed and tested legal system, including the recognition of copyright and patent protections, provides both companies and investors alike with a degree of comfort absent in some other emerging markets. This, coupled with good disclosure, accounting and regulatory standards makes India a more transparent market, vitally important when considering investment opportunities.

Portfolio construction

This paper details some of the current and future opportunities that India offers the long term investor. However, this opportunity is not without risks. Any number of internal and external factors could derail India's growth story. This paper aims to give a flavour of India, not a definitive account of all its facets. It highlights some of the strengths and weaknesses of the India story, for it is often deficiencies and areas of underperformance that offer the greatest opportunities.

It is not the intention of this paper to encourage investors to play the Indian growth story in isolation. In particular, India is often compared to China. The markets share many common traits leading to some observers asking 'Is India the next China?' The simple answer is no. While on the face of it there are similarities, the growth models differ widely and provide different investment opportunities. It is not a case of choosing between India and China but more a case of India *and* China – Chindia – that is likely to be a key driver in the Asian region.

Nor would we encourage investors to access India within the limited scope of a BRIC portfolio. While the long-term case for the Brazil, Russia, India and China economies is genuine and compelling, it is a sub-set of a wider picture. It is important to understand the BRIC economies, as they are increasingly important in world economic terms. But investors should not ignore other emerging markets. Investors make money by investing in quality companies regardless of geographic location. Investors should widen their opportunity set to include a more encompassing suite of emerging markets and benefit from the additional geographical and sector diversification such an approach offers.

Investors should therefore seek exposure to India as part of their emerging markets exposure within their international equity allocation. However, world benchmarks are backwards-looking, representing the world order of the last century, providing no guide to

where future growth opportunities lie. Given many international equity fund managers are unwilling to diverge significantly from benchmark, many investors are underweight emerging markets. Investors should review their international exposure, to ensure portfolios are forwards-looking and exposed to new growth opportunities. While some international equity funds have increased weightings to emerging markets, this is often only to the largest stocks and markets in the index. Investors should also question whether they truly possess the knowledge, experience and resources to successfully manage money in these more volatile markets.

In Aberdeen's view, investors are best to seek exposure to India and other emerging markets by tilting existing international equity portfolios through the use of either global emerging market funds or regional Asian funds.

There has been surprisingly little independent research on the optimal allocation to emerging markets for Australian investors. However, a 10% to 15% allocation to an Asian regional portfolio, or 20% to a global emerging market portfolio, as part of the overall allocation to international equities would provide additional exposure and maintain a balanced portfolio. As a reference, at 30 June 2006, Aberdeen's International Equity Fund had a 16.8% allocation to Asia ex-Japan and 23.3% to emerging markets in total.

In summary, emerging markets currently offer some of the best long-term investment opportunities for investors in international equities. Therefore India, like China, and the other emerging markets, should be a pre-requisite for a diversified international equity portfolio. For perhaps this elephant can fly. ■

ENDNOTES

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