A Foreign Institutional Investor from U.K. proposes to invest £ 1 million in an emerging market. After a careful analysis of future prospects, India and Hong Kong are short listed. For the next year, which is also the holding period for the FII, expected rates of returns are 15% and 12% in Indian and Hong Kong markets respectively. Withholding tax rates applicable on the returns earned are 15% in India and 12% in Hong Kong. Other information available with the FII includes:

Current exchange rates

Rs./£	69.50/70
HK $/£	11.15/18

Expected inflation for the next year

U.K. – 2%
India – 4%
Hongkong – 3%

You are required to find out the rate of return in India and Hong Kong in £ terms. Assume purchasing power parity holds good in both the countries.

Alt 1 : Investment in India(₹1m)

Step 1 : Sell £ spot at ₹ 69.5/£ and therefore ₹ amount = ₹ 69.5 m

Step 2 : Invest ₹ 69.5 m in India at a post tax return of (15 × 0.85)% i.e. 12.75%

Step 3 : Expected Rupee inflow after 1 year:
= 69.5 × 1.1275 = ₹ 78.36 m

Step 4 : Expected Spot for buying £ as per PPP

$$= \left(69.7 \times \frac{1.04}{1.02}\right) = ₹71.067 / £$$

Step 5 : Expected £ inflow after 1 year = $\frac{78.36}{71.067}$ = £ 1.1026 m

Step 6 : Expected Return = $\left(\frac{1.1026 - 1}{1}\right) \times 100 = 10.26\%$

Alternative 2 : Investment in Hong Kong (£ 1 m)

Step 1 : Sell £ spot at HK$ 11.15/£ and therefore HK$ = 11.15

Step 2 : Invest 11.15m in Hong Kong at a post tax return of (12 × 0.88) i.e. 10.56%

Step 3 : Expected Rupee inflow in 1 year
= 11.15 × 1.1056 = 12.3274 HKD

Step 4 : Expected Sport after buying £ as per PPP

$$= \left(11.18 \times \frac{1.03}{1.02}\right) = \text{HKD}\,11.289 / £$$

Step 5 : Expected £ inflow after 1 year = $\frac{12.3274}{11.289}$ = £ 1.0919

Step 6 : Expected Return = $\left(\frac{1.0919 - 1}{1}\right) \times 100 = 9.19\%$